NATIONAL
TREASURY

REPUBLIC OF SOUTH AFRICA

EXPLANATORY MEMORANDUM

ON THE

TAXATION LAWS AMENDMENT BILL, 2010

**(SUBMITTED TO THE STANDING COMMITTEE ON FINANCE
10 MAY 2010)**

[W.P. –- ‘10]

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1. INCOME TAX: RATES AND THRESHOLDS (Appendix I)

Table I: Current rates for individuals and special trusts:

Taxable income	Rate of tax
Not exceeding R132 000	18 per cent of the taxable income
Exceeding R132 000 but not exceeding R210 000	R23 760 plus 25 per cent of amount by which taxable income exceeds R132 000
Exceeding R210 000 but not exceeding R290 000	R43 260 plus 30 per cent of amount by which taxable income exceeds R210 000
Exceeding R290 000 but not exceeding R410 000	R67 260 plus 35 per cent of amount by which taxable income exceeds R290 000
Exceeding R410 000 but not exceeding R525 000	R109 260 plus 38 per cent of amount by which taxable income exceeds R410 000
Exceeds R525 000	R152 960 plus 40 per cent of amount by which taxable income exceeds R525 000

Table II: Proposed rates for individuals and special trusts:

Taxable income	Rate of tax
Not exceeding R140 000	18 per cent of the taxable income
Exceeding R140 000 but not exceeding R221 000	R25 200 plus 25 per cent of amount by which taxable income exceeds R140 000
Exceeding R221 000 but not	R45 450 plus 30 per cent of amount by

exceeding R305 000	which taxable income exceeds R221 000
Exceeding R305 000 but not exceeding R431 000	R70 650 plus 35 per cent of amount by which taxable income exceeds R305 000
Exceeding R431 000 but not exceeding R552 000	R114 750 plus 38 per cent of amount by which taxable income exceeds R431 000
Exceeds R552 000	R160 730 plus 40 per cent of amount by which taxable income exceeds R552 000

Table III: Current rate for trusts (no change proposed):

Taxable Income	Rate of Tax
All taxable income	40 per cent of the taxable income

Table IV: Current rate for companies (no change proposed):

Taxable Income	Rate of Tax
All taxable income	28 per cent of the taxable income

Table V: Current rates for small business corporations (no change proposed):

Taxable Income	Rate of Tax
Not exceeding R57 000	0 per cent of taxable income
Exceeding R57 000 but not exceeding R300 000	10 per cent of the amount by which the taxable income exceeds R57 000
Exceeding R300 000	R24 580 plus 28 per cent of the amount by which the taxable income exceeds R300 000

Table VI: Current rates for registered micro businesses (no change proposed):

Taxable turnover	Rate of tax
Not exceeding R100 000	0 per cent of taxable turnover
Exceeding R100 000 but not exceeding R300 000	R1 per cent of amount by which taxable turnover exceeds R100 000
Exceeding R300 000 but not exceeding R500 000	R2 000 plus 3 per cent of amount by which taxable turnover exceeds R300 000
Exceeding R500 000 but not exceeding R750 000	R8 000 plus 5 per cent of amount by which taxable turnover exceeds R500 000
Exceeds R750 000	R20 500 plus 7 per cent of amount by which taxable turnover exceeds R750 000

Table VII: Current rates for gold mining companies (no change proposed):

Taxable Income	Rate of Tax
On gold mining taxable income	See formula in paragraph 4*(b)* of Appendix I
On non gold mining taxable income	28 per cent of the taxable income
On non gold mining taxable income if exempt from STC	35 per cent of the taxable income
On recovery of capital expenditure	Greater of average rate or 28 per cent of the taxable income

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All taxable income	28 per cent of the taxable income

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Taxable Income	Rate of Tax
All taxable income	33 per cent of taxable income

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Taxable Income	Rate of Tax
All taxable income	33 per cent of taxable income

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Taxable income of company policyholder fund	28 per cent of taxable income
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All taxable income from South African source	33 per cent of taxable income

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Taxable income from benefits	Rate of tax
Not exceeding R22 500	0 per cent of taxable income
Exceeding R22 500 but not exceeding R600 000	18 per cent of taxable income exceeding R22 500
Exceeding R600 000 but not exceeding R900 000	R103 950 plus 27 per cent of taxable income exceeding R600 000
Exceeding R900 000	R184 950 plus 36 per cent of taxable income exceeding R900 000

Table XIV: Current rates for retirement lump sum benefits (no change proposed):

Taxable income from benefits	Rate of tax
Not exceeding R300 000	0 per cent of taxable income
Exceeding R300 000 but not exceeding R600 000	R0 plus 18 per cent of taxable income exceeding R300 000
Exceeding R600 000 but not exceeding R900 000	R54 000 plus 27 per cent of taxable income exceeding R600 000
Exceeding R900 000	R135 000 plus 36 per cent of taxable income exceeding R900 000

Table XV: Current rebates

Description	Amount
Primary rebate	R9 756
Secondary rebate	R5 400

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Description	Amount
Primary rebate	R10 260
Secondary rebate	R5 675

Income Tax: Monetary thresholds subject to periodic legislative change:

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Description (The contents of this column are solely for convenience and shall be of no force or effect)	Reference to Income Tax Act, 1962	Monetary amount
Broad-based employee share schemes		
Maximum exemption for shares received by an employee in terms of a broad-based employee share plan	Definition of "qualifying equity share" in section 8B(3)	R50 000
Maximum deduction for shares issued by an employer in terms of a broad-based employee share plan	The proviso to section 11(*l*A)	R10 000
Exemption for interest and certain dividends		
Exemption for foreign dividends and interest from a source outside the Republic which are not otherwise exempt	Section 10(1)*(i)*(xv)*(aa)*	R3 700
In respect of persons 65 years or older, exemption for interest from a source within the Republic and dividends (other than foreign dividends) which are not otherwise exempt	Section 10(1)*(i)*(xv)*(bb)*(A)	R32 000
In respect of persons younger than 65 years, exemption for interest from a source within the Republic and dividends (other than foreign dividends) which are not otherwise exempt	Section 10(1)*(i)*(xv)*(bb)*(B)	R22 300
Annual donations tax exemption		
Exemption for donations made by entities	Section 56(2)*(a)* and the proviso thereto	R10 000
Exemption for donations made by individuals	Section 56(2)*(b)*	R100 000
Capital gains exclusions		
Annual exclusion for individuals and special trusts	Paragraph 5(1) of Eighth Schedule	R17 500
Exclusion on death	Paragraph 5(2) of Eighth	R120 000

	Schedule	
Exclusion in respect of disposal of primary residence (based on amount of capital gain or loss on disposal)	Paragraph 45(1)*(a)* of Eighth Schedule	R1,5 million
Exclusion in respect of disposal of primary residence (based on amount of proceeds on disposal)	Paragraph 45(1)*(b)* of Eighth Schedule	R2 million
Maximum market value of all assets allowed within definition of small business on disposal when person over 55	Definition of "small business" in paragraph 57(1) of Eighth Schedule	R5 million
Exclusion amount on disposal of small business when person over 55	Paragraph 57(3) of Eighth Schedule	R750 000

Table XVIII: Retirement savings thresholds

Description (The contents of this column are solely for convenience and shall be of no force or effect)	Reference to Income Tax Act, 1962	Monetary amount
Deductible retirement fund contributions		
Pension fund monetary ceiling for contributions	Proviso to section 11*(k)*(i)	R1 750
Pension fund monetary ceiling for arrear contributions	Paragraph *(aa)* of proviso to section 11*(k)*(ii)	R1 800
Retirement annuity fund monetary ceiling for contributions (if also a member of a pension fund)	Section 11*(n)(aa)*(B)	R3 500
Retirement annuity fund monetary ceiling for contributions (if not a member of a pension fund)	Section 11*(n)(aa)*(C)	R1 750
Retirement annuity fund monetary ceiling for arrear contributions	Section 11*(n)(bb)*	R1 800
Permissible lump sum withdrawals upon retirement		
Pension fund monetary amount for permissible lump sum withdrawals	Paragraph (ii)*(dd)* of proviso to paragraph *(c)* of definition of **"pension**	R50 000

	fund" in section 1	
Retirement annuity fund monetary amount for permissible lump sum withdrawals	Paragraph *(b)*(ii) of proviso to definition of **"retirement annuity fund"** in section 1	R50 000

Table XIX: Deductible business expenses for individuals

Description (The contents of this column are solely for convenience and shall be of no force or effect)	Reference to Income Tax Act, 1962	Monetary amounts
Car allowance		
Ceiling on vehicle cost	Section 8(1)*(b)*(iiiA)*(bb)*(A)	R400 000
Ceiling on debt relating to vehicle cost	Section 8(1)*(b)*(iiiA)*(bb)*(B)	R400 000

Table XX: Employment-related fringe benefits

Description (The contents of this column are solely for convenience and shall be of no force or effect)	Reference to Income Tax Act, 1962	Monetary amounts
Exempt scholarships and bursaries		
Annual ceiling for employees	Paragraph (ii)*(aa)* of proviso to section 10(1)*(q)*	R100 000
Annual ceiling for employee relatives	Paragraph (ii)*(bb)* of proviso to section 10(1)*(q)*	R10 000
Exempt termination benefits	Section 10(1)*(x)*	R30 000
Medical scheme contributions		
Monthly ceiling for schemes with one beneficiary	Section 18(2)*(c)*(i)*(aa)* and paragraph 12A(1)*(a)* of Seventh Schedule	R670
Monthly ceiling for schemes with two beneficiaries	Section 18(2)*(c)*(i)*(bb)* and paragraph 12A(1)*(b)* of Seventh Schedule	R1 340
Additional monthly ceiling for each additional beneficiary	Section 18(2)*(c)*(i)*(cc)* and paragraph 12A(1)*(c)*	R410

	of Seventh Schedule	
Awards for bravery and long service	Paragraphs *(a)* and *(b)* of further proviso to paragraph 5(2) of Seventh Schedule	R5 000
Employee accommodation	Paragraph 9(3)*(a)*(ii) of Seventh Schedule	R57 000
Accommodation for expatriate employees	Paragraph 9(7B)(ii) of Seventh Schedule	R25 000
Exemption for *de minimis* employee loans	Paragraph 11(4)*(a)* of Seventh Schedule	R3 000
Additional employer deductions for learnerships		
Monetary ceiling of additional deduction for the employer when utilising a learnership agreement with an employee	Section 12H(2)	R30 000
Monetary ceiling of additional deduction for the employer in the case of an employee completing a learnership agreement	Section 12H(3) and (4)	R30 000
Monetary ceiling of additional deduction for the employer involving a learnership agreement with an employee with a disability	Section 12H(5)	R20 000

Table XXI: Depreciation

Description (The contents of this column are solely for convenience and shall be of no force or effect)	Reference to Income Tax Act, 1962	Monetary amounts
Small-scale intellectual property	Paragraph *(aa)* of proviso to section 11(*g*C)	R5 000
Urban Development Zone incentive	Section 13*quat*(10A)	R5 million

Table XXII: Miscellaneous

Description (The contents of this column are solely for convenience and	Reference to Income Tax Act, 1962	Monetary amounts

shall be of no force or effect)		
Low-cost housing		
Maximum cost of residential unit where that residential unit is an apartment in a building	Paragraph *(a)* of definition of “low-cost residential unit” in section 1	R250 000
Maximum cost of residential unit where that residential unit is a building	Paragraph *(b)* of definition of “low-cost residential unit” in section 1	R200 000
Industrial policy projects		
Maximum additional investment allowance in the case of greenfield projects with preferred status	Section 12I(3)*(a)*	R900 million
Maximum additional investment allowance in the case of other greenfield projects	Section 12I(3)*(a)*	R550 million
Maximum additional investment allowance in the case of brownfield projects with preferred status	Section 12I(3)*(b)*	R550 million
Maximum additional investment allowance in the case of other brownfield projects	Section 12I(3)*(b)*	R350 million
Maximum additional training allowance (per employee)	Section 12I(5)*(a)*	R36 000
Maximum additional training allowance in the case of industrial policy projects with preferred status	Section 12I(5)*(b)*(i)	R30 million
Maximum additional training allowance in the case of other industrial policy projects	Section 12I(5)*(b)*(ii)	R20 million
Minimum cost of manufacturing assets for greenfield projects	Section 12I(7)*(a)*(i)*(aa)*	R200 million
Amounts to be taken into account in determining whether an industrial project constitutes a brownfield project	Section 12I(7)*(a)*(i)*(bb)*(A) Section 12I(7)*(a)*(i)*(bb)*(B)	R30 million R200 million
Venture capital companies		
Annual deduction limit (natural persons)	Section 12J(3)*(a)*	R750 000
Lifetime deduction limit (natural persons)	Section 12J(3)*(a)*	R2,25 million

36 months minimum investment (in respect of the acquisition of qualifying shares in a junior mining company)	Section 12J(6A)*(a)*(i)	R150 million
36 months minimum investment (in respect of the acquisition of qualifying shares in companies other than junior mining companies)	Section 12J(6A)*(a)*(ii)	R30 million
After 36 months, at least 80 per cent of the expenditure incurred by a venture capital company must be incurred in respect of qualifying shares in a junior mining company, with assets of which the book value does not exceed the amount indicated immediately after the issue	Section 12J(6A)*(b)*(i)	R100 million
After 36 months, at least 80 per cent of the expenditure incurred by a venture capital company must be incurred in respect of qualifying shares in a company, other than a junior mining company, with assets of which the book value does not exceed the amount indicated	Section 12J(6A)*(b)*(ii)	R10 million
Presumptive turnover tax		
A person qualifies as a micro business for a year of assessment where the qualifying turnover of that person for that year does not exceed the amount indicated	Paragraph 2(1) of Sixth Schedule	R1 million
Maximum of total receipts from disposal of immovable property and assets of a capital nature by micro business	Paragraph 3*(e)* of Sixth Schedule	R1,5 million
Minimum value of individual assets and liabilities in respect of which a micro business is required to retain records	Paragraphs 14*(c)* and *(d)* of Sixth Schedule	R10 000
Public benefit organisations		
PBO trading income exemption	Section 10(1)*(c*N*)*(ii)*(dd)*(ii)	R150 000
Deduction of donations to	Section 18A(1C)*(a)*(ii)	R1 million

transfrontier parks		
Housing provided by a PBO: maximum monthly income of beneficiary household	Paragraph 3*(a)* of Part I of Ninth Schedule and paragraph 5*(a)* of Part II of Ninth Schedule	R7 500
Recreational clubs		
Club trading income exemption	Section 10(1)*(cO)*(iv)*(bb)*	R100 000
Prepaid expenses		
Maximum amount of deferral	Paragraph *(bb)* of proviso to section 23H(1)	R80 000
Small business corporations		
Maximum gross income	Section 12E(4)*(a)*(i)	R14 million
Housing associations		
Investment income exemption	Section 10(1)*(e)*	R50 000

Table XXIII: Administration (Taxation Laws Second Amendment Bill)

Description (The contents of this column are solely for convenience and shall be of no force or effect)	Reference to Income Tax Act, 1962	Monetary amounts
Investment income exempt from provisional tax		
In the case of natural persons below age 65	Paragraph 18(1)*(c)*(ii) of Fourth Schedule	R20 000
In the case of natural persons over age 65	Paragraph 18(1)*(d)*(i) of Fourth Schedule	R120 000
S.I.T.E. threshold	Items *(a)* and *(b)* of paragraph 11B(2) and items *(a)*, *(b)*(ii) and *(b)*(iii) of paragraph 11B(3) of Fourth Schedule	R60 000
Threshold in respect of automatic appeal to High Court	Section 83(4B)*(a)*	R50 million

Table XXIV: Value Added Tax: Monetary thresholds subject to periodic legislative change

Description	Reference to Value-	Monetary amount

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(The contents of this column are solely for convenience and are of no force or effect)	Added Tax Act, 1991	
Registration		
-Compulsory	Section 23(1)*(a)*	R1 million
-Voluntary	Section 23(3)*(b)*, *(c)* and *(d)*	R50 000
-Commercial accommodation	Paragraph *(a)* of definition of 'commercial accommodation' in section 1	R60 000
-Payments basis of VAT registration	Section 15(2)*(b)*(i)	R2,5 million
-Exception to payments basis : in respect of supplies of goods or services made by a vendor	Section 15(2A)	R100 000
Tax invoices		
-Abridged tax invoice	Section 20(5)	R3 000
-No tax invoice required	Section 20(6)	R50
Tax periods		
- Category C (monthly) submission of VAT 201 return	Section 27(3)*(a)*(i)	R30 million
-Category D (6-monthly) submission of VAT 201 return	Section 27(4)*(c)*(i)	R1,5 million
-Category F (4-monthly) submission of VAT 201 return	Section 27(4B)*(a)*(i)	R1,5 million

Table XXV: Transfer Duty: Imposition

Value	Rate of Tax
Does not exceed R500 000	0%
Exceeding R500 000 but not exceeding R1 million	5% on such value
Exceeds R 1 million	8% on such value

Table XXVI: Diamond Export Levy: Rate and Exemptions

Exemption from levy (Levy not applicable in following instances)	Applicable levy
	5% of gross sales
Large producers	
-40% of the producer's gross sales must be to South African diamond beneficiators, and	

-total gross sales must exceed R3 billion	
Medium producers	
-15% of the producer’s gross sales must be to South African diamond beneficiators, and	
-total gross sales exceeds R20 million but does not exceed R3 billion	
Small producers	
-total gross sales does not exceed R20 million	

Table XXVII: Royalty Act: Rate and Exemption

Royalty formulae	Rate
-**Refined**: 0.5 +[EBIT / (gross sales x 12.5)] x100	Cannot exceed 5%
-**Unrefined**: 0.5 + [EBIT / (gross sales x 9)] x 100	Cannot exceed 7%
Exemption for small business	
-Gross sales of extractor does not exceed R20 million	

Table XXVIII: Estate Duty: Rates, thresholds and abatement

Description	Rate / Amount
Imposition of estate duty	20% of the dutiable amount of the estate
Reduction of duty payable	
reduced as follows of the second dying dies within 10 years of the first dying:	
- 2 years	100%
- 2-4 years	80%
- 4-6 years	60%
- 6-8 years	40%
- 8-10 years	20%
Exemption	
Abatement	R3.5 million

2. INCOME TAX: MISCELLANEOUS INDIVIDUALS AND SAVINGS AMENDMENTS

2.1. EMPLOYER-PROVIDED MOTOR VEHICLES

[Sections 3(4)(f), 8(1)(b) of the Income Tax Act; (b) of the paragraph (1) definition of remuneration in the Fourth Schedule; paragraphs 7(1)(a) and (b), 7(2), 7(4), 7(5), 7(7), 7(8) and 7(9) of the Seventh Schedule and GN 177 Government Gazette 28850 of 24 February 2006]

I. Background

Employers often provide their employees with a travel allowance to defer business-related car travel expenses. Some employers alternatively provide their employees with the use of a company-owned motor vehicle for the same purpose.

Private use of an employer-provided company-owned vehicle is a taxable fringe benefit. A monthly fringe benefit of 2.5 per cent of the vehicle's determined value is added to the employee's salary. If an employee is given the use of more than one vehicle, the fringe benefit included in the employee's income is generally at a rate of 2.5 per cent per month in respect of the first vehicle and 4 per cent per month in respect of each additional vehicle. The difference in rates is based on the starting assumption. In the case of the first vehicle, some business use is presumed; in the case of the additional vehicles, all use is presumed private unless proven otherwise.

The above monthly percentages are only a starting point. An employee may reduce the taxable fringe for fuel and maintenance expenses directly incurred by that employee. SARS also has further discretion to reduce the above percentages as long as private use of a vehicle is less than 10 000 kilometers during the year of assessment.

II. Reasons for change

Over the last several years, the rules for claiming the travel allowance have steadily become more restrictive. Most recently in 2009, the deemed business kilometer method was repealed. As a result, taxpayers seeking to claim a travel allowance must now maintain travel log books showing business use.

In view of these changes to the car allowance, corresponding changes are required for the employer car fringe benefit rules. Both sets of rules must roughly reach the same outcome so as to prevent arbitrage.

III. Proposal

A. Starting percentage rate change

The starting percentage for all employer-provided cars will henceforth be based on the presumption that all employee use is deemed to be private unless facts are provided to the contrary. The percentage rate for employer-provided vehicles (including the first) will now be 4 per cent per month of the vehicle's determined value (instead of the current 2.5 per cent rate for the first car). This starting presumption matches the revised car allowance rules, which limit the allowance to proof of business use via the travel log book.

The rules for calculating determined value will generally be the same although it will be altered slightly. For example, it will include the costs of a maintenance plan. The current exclusion of value-added tax makes little sense since the purchase of a company car largely includes the value-added tax without any ability to claim an input credit. The proposed inclusion of value-added tax in the determination also matches the current calculation rules for the car travel allowance.

B. Revised allowable offsets

As stated above, the starting point for the fringe benefit calculation assumes no business use unless proven to the contrary. The starting point for the calculation also assumes that all operating expenses are incurred by the employer. Given these assumptions, on assessment employees are entitled to reduce the fringe benefit calculation for both actual business use and for private expenses incurred by employees.

1. Across-the-board business-use percentage reduction

Employees can obtain an across-the-board reduction to the extent that proof of actual business kilometer usage is provided. This across-the-board reduction is determined by simply using a ratio of business use over total use as applied against the 4 per cent presumed monthly inclusion. This reduction is calculated by making use of the cost-scale method (based on Ministerial regulation(GN 177 Government Gazette 28850 of 24 February 2006; section 8 (b) (1)(iii)) and is subsequently subtracted from the four percent.

2. Employee assumption of private costs / expenses

Employees may obtain offsets relating to private use to the extent payments are undertaken by the employee, for:

- Insurance

- Licensing fees
- Fuel and
- Actual maintenance costs.

Insurance and licensing costs: If an employee directly pays all insurance and licensing costs, the employee can obtain an additional reduction for the private element of the costs (the business element already being reduced by virtue of the across-the-board reduction). This reduction is determined by simply using a ratio of private use over total use as applied against the actual insurance and licensing costs incurred.

Maintenance: If an employee directly pays all maintenance, the employee can obtain an additional reduction for the private element of the actual costs (the business element already being reduced by virtue of the across-the-board reduction). This reduction is determined by simply using a ratio of private use over total use as applied against the actual maintenance costs incurred.

Fuel: If an employee directly pays all fuel, the employee can obtain an additional reduction for the private element of the costs (the business element already being reduced by virtue of the across-the-board reduction). These reductions are based on deemed costs relating to total kilometers driven. More specifically, the starting point for the fuel reduction is to determine the cost scale for these items based on Ministerial regulation (GN 177 Government Gazette 28850 of 24 February 2006; section 8(b)(1)(iii)). The fuel amount is then multiplied by total private kilometers driven.

Employer reimbursement: In this scenario, the employee directly pays all insurance and licensing and/or fuel and/or maintenance costs, but the employer partially reimburses the employee for the amounts so paid. Conceptually and technically, the same approach is followed as applicable above. However, in view of the employer reimbursement, the allowed reductions for insurance and licensing and/or fuel and/or maintenance must be reduced by the extent of the partial reimbursement by the employer.

Note: None of the reductions refer to above may reduce the net fringe benefit below zero.

Example 1 (Employer covering all costs):
Facts: An employer purchases a vehicle for sole use by an employee. The employee maintains a logbook indicating a total of 40 000 kilometers travelled of which 10 000 are business kilometers. The employer pays all costs.

Result: The starting point for the monthly fringe benefit calculation is the 4 per cent inclusion rate. The withholding amount (PAYE) is 80 per cent of the 4 per cent, effectively 3,2 per cent per month. The actual reduction occurs on assessment.
On assessment for all cases, a business use reduction is applied. This is done using the cost-scale method as provided for in the regulation. See GN 177 Government Gazette 28850 of 24 February 2006.

Using the facts above (10 000 kilometers for business use) the business use reduction calculation consist of :

Fixed cost component	R2,494 x 10 000km	= R24 940
Fuel cost componet	R0.79 x 10 000km	= R7 900
Maintenance component	R0,463 x 10 000km	= R4 630
TOTAL AMOUNT		R37 470

The net fringe benefit, after considering the business use reduction, would be R106 530 (The gross fringe benefit of R144 000 less R37 470).

Example 2 (Employee covers "fuel"):
Facts: Employee has been granted the right to use a motor vehicle. The motor vehicle was acquired by the employer at a cost of R300 000 (including VAT). Employee maintains a logbook indicating a total of 40 000 kilometers travelled of which 10 000 are business kilometers. Under the terms of the employment contract, employee is solely responsible for all fuel costs.

Result: The monthly withholding for PAYE purposes will be 80 per cent of the 4 per cent with concomitant reductions effected on assessment.

In calculating the net fringe benefit the business use reduction would be be the same in example 1, with further relief provided where employee pays for fuel.

In considering the fuel payment by the employee, the fringe benefit is further reduced as follows:
<u>Fuel cost component (pvt kms) R0,79 x 30 000km = R23 700</u>

The net fringe benefit, after considering the business use reduction and the employee paid fuel, would be R82 830 (R144 000 – R37 470 – R23 700).

Example 3 (Employee covers all fuel with some employer reimbursement):
Facts: The facts are the same as *Example 2*, except that Employer paid employee a partially reimbursed Employee (R10 000 of R25 000) for fuel relating to business travel.

Result: Employee can obtain an additional reduction for the private element of the actual net cost of the fuel payment (employee payment for fuel less reimbursement - the business element already being reduced by virtue of the across-the-board reduction), by simply using a ratio of private

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use over total use as applied against the actual net fuel costs incurred. The private element is calculated as follows

Private kms = 75%
Total fuel payment = R25 000
Reimbursement = R10 000
Net fuel payment = R15 000
Private fuel claim = R11 250 (75% of R15 000)

C. Car travel allowance

Taxpayers cannot claim a double allowance/offset in respect of employer-provided cars. More specifically, employees cannot claim car allowance in respect of employer-provided cars. Only the offsets described above will be allowed.

D. Withholding

The monthly fringe benefit calculation is designed to roughly mirror the travelling allowance arrangement. Reductions based on the cost-scale method (kilometers travelled) are determined on the date of assessment. For the purposes of the monthly PAYE withholding, the full fixed 4 percentage will be reduced automatically by 20% giving an effective monthly PAYE inclusion rate of 3, 2%. Final adjustments for actual business kilometers and private coverage of actual private kilometers (or the lack thereof) will occur on final assessment.

Example 4: (Employee bears all fuel costs for private use)
Facts*:* Employee is granted the right to use a motor vehicle. The motor vehicle is acquired by the employer at a cost of R300 000 (including VAT). Under the terms of the contract, the employee is solely responsible for all fuel for private travel with all other expenses covered by Employer. Employee travels a total of 40 000 kilometers, of which 10 000 kilometers represents business travel.

Result: For purposes of withholding, Employee has a monthly withholding of 3,2 per cent (4 per cent less 20 per cent) of R300 000, amounting to R115 200 per annum. The business kilometers travelled are only relevant upon assessment.

IV. Effective date

The above proposal will apply to years of assessment commencing on or after 1 March 2011.

2.2. MERGING LUMP SUM TERMINATION EMPLOYMENT PAYMENTS INTO THE PENSIONS WITHDRAWAL TAX TABLE

[Applicable provisions: Sections 5(10), 7A (4A) and 10(1)(x) of the Income Tax Act; paragraph 2(1) of the Second Schedule and paragraph 8 of Appendix I]

I. Background

When taxpayers are retrenched, employers often pay a severance award that is usually linked to the taxpayer's period of service. In terms of the Basic Conditions of Employment Act, a typical severance package would provide a minimum of one week salary per each completed year of service. Under current law, these payments qualify for a R30 000 exemption with the balance being taxed pursuant to an averaging formula. Given the ongoing concerns about retrenched workers during the current global economic downturn, additional tax relief was afforded in 2009. If a taxpayer withdraws a lump sum benefit from a retirement fund as a result of retrenchment, the 2009 changes provide that the withdrawal benefit will be taxed as if the taxpayer had retired in respect of these retirement funds. This lump sum treatment means that the sum receives the benefit of the special retirement tables, including the R300 000 life-time exemption.

II. Reasons for change

The dual relief system for retrenched workers (one for employer-provided severance pay and the other for pre-retirement fund retrenchment withdrawals) makes little sense. Both sums achieve the same interim economic support for workers suffering a temporary shortfall. The averaging mechanism for retrenched severance pay offered by employers is also too complicated.

III. Proposal

Retrenched workers receiving a lump sum upon retrenchment (or pending retrenchment) will be subject to the same tax treatment regardless of whether that lump sum is obtained from an employer or by withdrawing funds from pre-existing retirement funds. Both sums will be subject to the special rates table for lump sum retirement withdrawals (including the R300 000 exemption) with the same principles of life-time aggregation. Effectively phasing-out the "additional" R30 000. Employer-provided severance packages for reasons of age, sickness, accident, injury, or mental incapacity will also receive the same tax benefit.

IV. Effective date

This proposal will apply to all lump sum termination of employment payments received or accrued on or after 1 March 2011.

2.3. KEY EMPLOYEE INSURANCE SCHEMES

[Applicable provisions: Paragraph (m) of "gross income" in section 1 of the Income Tax Act; new paragraph (mA) of "gross income" in section 1 of the Income Tax Act; new definition of "severance benefit" in section 1 of the Income Tax Act; section 11(w) of the Income Tax Act; new section 23(p) of the Income Tax Act]

I. Background

Employers often use insurance policies to protect themselves against the loss of profits arising from the loss of key employees. These plans typically involve a life or disability insurance contract in respect of a key employee (or director). Insured events typically include disability, severe illness or dread disease and death. In some cases, key employee/director owners guarantee debts of their business and the insurance covers the debt upon loss of the key employee/director.

Under a genuine key person plan, an employer generally obtains an immediate deduction for policy premiums when incurred. Benefits payable under these policies are included in the employer's gross income when the insured event subsequently arises.

II. Reasons for change

Salary is generally deductible by employers and simultaneously includible as ordinary revenue by employees. The rules for non-cash fringe benefits are largely intended to work the same way. For instance, employer-provided life insurance for the benefit of employees creates deductible premiums for employers with a simultaneous inclusion of the same amount for employees.

Although many key employee plans have legitimate uses as discussed above, some key employee plans are arranged to create a tax mismatch. In schemes of this nature, the key employee plan is allegedly designed for the employer, but the expected insurance proceeds are actually intended for the benefit of employees. If form governs, the employer obtains a deduction as the premiums are paid. The insurance payout will trigger an ordinary inclusion for the employer, but the employer will then deduct the pre-planned payment of these proceeds to the employee (leaving the employer in a tax neutral position). The employee will typically treat the sum as a retrenchment benefit eligible for certain tax benefits. The net result is an upfront deduction for the employer and a delayed (possibly reduced) inclusion for the employee.

Existing anti-avoidance legislation has largely curbed the mismatch schemes outlines. However, some mismatch schemes remain viable. The anti-avoidance restrictions also sometimes undermine legitimate commercial practices, such as the use of insurance as collateral for debts owed. It is these concerns that require remedial legislation.

III. Proposal

A. Revised Entry Requirements

In view of the above concerns, it is proposed that the entry requirements for deductible key person insurance schemes be wholly revised. The objective is to continue the deduction for employers in the case of legitimate schemes (even allowing for commercial practices previously disallowed) while completely eliminating any remaining mismatch schemes outlined above.

Under the revised entry requirements:

- Entry requirement #1: The insured event for employers is restricted to key employee (or director) job terminations stemming solely from employee (or director) death, disability or severe illness.

- Entry requirement #2: Deductible premiums will be limited to term policies that solely cover the insured against insured risks. Policies with investment elements (e.g. whole life) will not be permitted.

- Entry requirement #3: The employer must be the sole owner and sole beneficiary of the policy throughout the year of assessment in which the premium is paid.

However, the deductibility of premiums will not be adversely impacted if: (i) a creditor of the employer is the owner of the policy or beneficiary of the insurance proceeds, and (ii) the insurance acts as security for a debt (or the debt was made on the strength of the policy) when the insurance policy was initially concluded for the purposes of the taxpayer's trade "to the extent" that the value of the policy does not exceed the amount of the debt in respect of which the policy is ceded or pledged.

- Entry requirement #4: No deduction is allowed if the key person insurance plan is part of a transaction, operation or scheme to make the benefits payable to an employee/director or their relatives. Benefits payable implicitly include benefits payable by virtue of a cession of the policy or by virtue of an intended change of beneficiaries.

As a side matter, it should be noted that employer deductions for key person insurance plans are only deductible by virtue of this provision. These premiums would either be viewed as non-deductible capital expenditure or the general deduction formula of section 11(a) would not be available because of the existence of this provision (see section 23B(3)).

B. Insurance payouts

As a general matter, key person insurance policies will give rise to ordinary revenue when paid up. However, if premiums incurred are partly or completely non-deductible, the payout is exempt to the extent of the non-deductible premiums. This calculation is determined according to a formula (exempt premiums over total premiums multiplied by the insurance pay out).

Special anti-avoidance rules apply if the proceeds of qualifying insurance policies (i.e. policies eligible to receive deductible premiums) are actually applied for the benefit of employees/directors and/or their relatives. These anti-avoidance rules apply even if the initial conclusion of the insurance policy was not intended for the benefit of an employee (or director). In these circumstances, two additional rules apply.

- Firstly, the employer loses any deductions under section 11 otherwise available if the insurance policy proceeds are (directly or indirectly) applied for the benefit of employees/directors and/or their relatives. This denial applies in addition to the general inclusion for the receipt and accrual of key person insurance policy proceeds.
- Secondly, any receipt or accrual of the insurance proceeds by an employer (or director) is treated as fully taxable ordinary revenue, i.e. not as a "severance benefit." In other words, the special relief table otherwise applicable to retrenchment-type benefits is no longer available.

IV. Effective dates

<u>Section 11(w):</u> In respect of deductions, this proposal will apply to all premiums incurred during any year of assessment commencing on or after 1 January 2011.

<u>Section 1 –</u> gross income (m) and (mA): In respect of key person insurance proceed payouts, "gross income (mA)" will apply to all receipts and accruals arising during any year of assessment commencing on or after 1 January 2011. In the case of "gross income (m)," this provision will

continue to apply in respect of insurance contracts concluded on or before1 January 2011.

Section 23(p): This proposal will apply in respect of employer expenditure incurred on or after 1 January 2011.

Section 1 - Definition of “severance benefit”: This proposal comes into operation on 1 March 2011 and applies in respect of amounts received or accrued on or after that date.

2.4 NARROWING THE INTEREST THRESHOLD EXEMPTION

[Applicable Provision: Section 10(1)(i)(xv) of the Income Tax Act]

I. Background

Interest income of domestic residents is generally taxable. However the interest exemption provides relief to domestic individuals. For the 2010 tax year, the thresholds relating to individuals below 65 years will be R22 300 (previously R21 000) and for individuals of 65 years and above is R32 000 (previously R30 000).

There is also a second exemption available for domestic individuals receiving or accruing foreign interest and dividends. For the 2010 tax year, this exemption will be R3 700 (previously R3 500). The domestic exemption for an individual accordingly reduces to the extent that the individual utilises the foreign interest and dividend exemption.

II. Reasons for change

The intended purpose of the domestic exemption is to promote savings that will flow into the general economy, especially savings by middle and lower income groups. The broad nature of the exemption means that the exemption applies across-the-board.

As a result of the exemption’s breadth, it has become a tax planning opportunity that sometimes offers little in the way of savings into the general economy. This planning opportunity has increased as the annual threshold increased over the years. Many of these planning opportunities involve family loans or loans between other connected persons, thereby creating distortions (deductible interest on the one side and a threshold level of exempt interest on the other). One common form of planning is for a shareholder to utilise loan capital as a means of financing a closely-held company (as opposed to the use of share capital). The interest gives rise to a deduction for the company while providing a threshold level of exempt interest on the other.

III. Proposal

The interest exemption should only be applicable to savings that flow into the general economy and all other forms of interest are to be taxable at marginal rates. Therefore, threshold exemption will be limited to the following:

- Interest bearing products listed on the JSE (such as corporate bonds of widely held companies & parastatals);
- Interest paid by any one of the three spheres of government;
- Interest paid by any bank that is regulated in terms of the Banks Act, Mutual Banks Act, Co-operatives Act and Dedicated Banks Bill,
- Interest paid by a friendly society registered under the Friendly Societies Act,
- Interest paid by a medical scheme registered under the Medical Schemes Act;
- Collective investment (money market) schemes and
- Interest from dealer or brokerage accounts.

The foreign interest and dividend exemption will remain the same. These forms of income are often subject to taxes in the foreign country in which the income arose, thereby triggering foreign tax (i.e. credits) rebates. The existence of these credits often means that the net tax resulting from these forms of income do not justify the enforcement or compliance burden associated with the potential tax yield.

IV. Effective date

The effective date is from the commencement of years of assessment ending on or after 1 January 2010.

2.5 POST RETIREMENT COMMUTATION (CONVERSION) OF ANNUITIES INTO LUMP SUMS

[Paragraphs (1) ("lump sum benefit" definition), 2(1)(a) and 3 of the Second Schedule paragraph 8(b)(i) of Appendix I]

I. Background

At retirement, a member of a pension fund or a retirement annuity fund may generally commute (i.e. convert) up to a maximum of one third of fund benefits for a lump sum. The remaining two thirds must be used to purchase a pension or annuity. Annuities can be in the form of guaranteed annuities (payable in a fairly even stream until death) or in the form of living annuities, the latter of which allow for corpus withdrawals between 2 ½ per cent and 17, 5 per cent per annum. Of the two types of annuities, living annuities are far more common.

Living annuities are generally payable over the period of retirement until death. Due to relatively high service costs stemming from the greater flexibility of living annuities, the rules for living annuities were changed so that living annuities could be commuted into lump sums once the size of these annuities falls below a certain threshold. This threshold is currently set at R50 000 at time of commutation and applies per insurer (as opposed to per contract). Note also that the 2/3rd annuity requirement for pension funds and retirement annuity funds is waived (for all forms of annuities) if annuity values would not otherwise exceed R50 000 at the time of retirement.

Annuity beneficiaries may change over time due to death. If a member dies, the annuity can be converted to a lump sum or may continue in the hands of a successor (typically a spouse). If the successor dies, the annuity can again be converted to a lump sum or may continue in the hands of a subsequent successor (typically a child or grandchild).

II. Reasons for change

The tax rules do not explicitly cover the commutation of living annuities into lump sums after retirement (except upon the member's death). The rules also do not fully cater for subsequent commutation of annuities by a successor who previously inherited an annuity from a deceased member. At the present time, the practice has been to treat all of the above amounts as gross income without the special relief table.

III. Proposal

All commutations of retirement annuities should be treated similarly (whether these commutations occur during the member's life or afterwards) as long as the annuity directly or indirectly stems from membership or past membership of a fund. All lumps sums resulting from these commutations should accordingly be treated as gross income eligible for the special retirement table relief.

The only difference in taxing these commutations lies in the application of the aggregation principle required by the special retirement tables. If the commutation occurs during the member's life or upon the member's death, aggregation will occur in respect of the member. If the commutation occurs during a successor's life or upon the successor's death, aggregation will occur in respect of the successor.

IV. Effective date

This proposal will apply to all lump sum commutations or death recoveries arising on or after 1 March 2011.

2.6 PARTIAL WIND-UP OF UMBRELLA FUNDS

[Paragraphs (a)(i)(bb) & (a)(ii)(aa) in the definitions of "pension preservation fund" and "provident preservation fund" contained in section 1 of the Income Tax Act]

I. Background

Unlike a closed pension fund offered by a single employer, an umbrella retirement fund allows employees of different employers to place their retirement savings in a single fund. Umbrella funds ostensibly offer a cheaper and easier alternative to running "stand alone" pension funds. However, owing to financial constraints, some employers are often unable to pay over contributions to the umbrella fund. Many of these employers eventually cease to participate in the umbrella fund. This process whereby an employer exits from an umbrella fund (with the fund otherwise remaining in tact) is referred to as a "partial wind-up."

II. Reasons for change

In a partial wind up, impacted employees may elect to:

- have the benefits paid in cash (unattractive because the payment triggers immediate tax, albeit with some relief from the special rates tables);
- transfer their benefits tax-free to an approved stand-alone retirement fund established by the employer (this option is often impossible if the employer is in financial difficulty);
- transfer their retirement benefits to a retirement annuity fund (unattractive since the retirement benefits are "locked in" until the age of 55); or
- transfer their retirement benefits to a pension preservation or provident preservation fund.

However, the last option may not be technically available to employees because the pension preservation fund and provident preservation fund definitions do not specifically allow for the receipt of amounts resulting from a partial wind-up of a pension or provident fund; only from a full wind-up. This technical anomaly places the retention of retirement benefits in potential jeopardy because a cash election seems to be the only option. This cash option is not conducive to a culture of savings.

III. Proposal

Given the above, pension preservation funds and provident preservation funds should be expressly allowed to receive payments or transfers of fund benefits pursuant to a partial wind-up. This clarification will strengthen the option of preserving employer-provided retirement savings.

IV. Effective date

This proposal will apply to all "transfers" of retirement benefits pursuant to a partial wind-up that occurs on or after 1 March 2011.

2.7 RETIREMENT FUND PAY-OUTS TO NON-MEMBERS

[Paragraph 4(1) of the Second Schedule to the Income Tax Act; 37 D (1)(a) of the Pension Funds Act]

I. Background

When a member resigns or withdraws from a retirement benefit fund, there are different periods of accrual. Accrual under the Income Tax occurs at the earliest of: the date the member elects to have retirement fund benefits paid in cash,the date on which fund benefits are transferred to another retirement fund, or
the date of the member's death.

Accrual under the Pension Funds Act is determined by the rules of the retirement fund, usually upon resignation. The Pension Funds Act does not expressly determine when retirement fund benefits accrue.

II. Reasons for change

On occasion, employer-provided retirement savings (such as pension or provident fund savings) may be paid by a retirement fund administrator directly to third parties. For example, a member may be indebted to the employer for the settlement of a housing loan guaranteed by the employer or for damages inflicted upon the employer. The full array of allowable third party payouts is listed under section 37D(1)(a) of the Pension Funds Act.

For tax purposes, these payouts create a gross income event that triggers a tax accrual only sometime after the cash payout. The net result is a delayed SARS tax directive for the payment. This timing mismatch places retirement fund administrators at risk during the interim period because remaining sums within a retirement may not be sufficient to cover the tax liability associated with the third party payout (nor should remaining funds be so applied as a matter of governance; instead, tax should be subtracted from the payout itself).

III. Proposal

It is proposed that the tax rules for lump sum benefits be revised to specifically account for third party payouts contemplated in section 37D(1)(d)(ii) of the Pension Funds Act. More specifically, these payouts will now trigger a tax accrual event at the moment of payout. Therefore, the timing of required tax directives will coincide with these third party payouts.

IV. Effective date

This proposal will apply to all deductions under section 37D(1)(a) arising on or after 1 March 2011.

2.8. TAX-FREE FRINGE BENEFITS FOR EMPLOYER-PROVIDED PROFESSIONAL FEES AND INDEMNITY INSURANCE

[Applicable Provisions: Paragraph 13(2)(b) of the Seventh Schedule]

I. Background

Certain professions require persons practicing within that profession to belong to a regulated institution. These institutions are responsible for setting standardised practices, ethical codes of conduct, promoting professional development and maintaining a register of members. Membership in these institutions comes at the cost of regular dues.

Some professions further require their members to obtain indemnity insurance while this insurance is often strongly advisable in others. Indemnity insurance seeks to protect the insured member against liability arising from professional negligence.

Professionals often pay for the above directly from their own salaries. However, some employers cover these benefits on behalf of employees, especially when these fees are an absolute or practical pre-requisite for engaging in the profession.

II. Reasons for change

An employee is deemed to have an accrual of a taxable benefit when an employer tenders payment to a third party for a debt owed by that employee (as long as the employee does not, or is not required to, reimburse the amount so paid). An exception exists to this deemed accrual in the case of subscriptions to a professional body. This exception applies if the employer pays subscriptions to a professional body on behalf of an employee when the employer requires membership in that body as a condition of employment.

An exemption for employer-provided professional subscriptions exists because this form of employer-provision is essentially a working condition fringe as opposed to a net enrichment for the employee. In essence, this cost would not have arisen but for it being a condition of employment / to practice.

III. Proposal

It is proposed that the exemption for professional dues be adjusted to more closely reflect commercial reality. Under the exemption as revised, professional dues paid by an employer on behalf of an employee will remain non-taxable subject to two criteria. Firstly, the duties of employment must involve the practice of the profession to which the fee relates. Secondly, the registration, certification or licensing operates as a pre-requisite for that person to practice within the relevant profession. This aspect of the exemption is much the same as current law, except that the focus is on the employee’s pre-requisite to practice within the profession as opposed to the precise needs of the specific employer. Compulsory professional dues of this kind most typically arise in respect of health professionals, lawyers, accountants and actuaries.

It is further proposed that legislation cater for employer-provision of premiums expended for indemnity insurance against profession-related negligent acts or omissions. This form of coverage is again a working condition fringe. Employees are either legally required to obtain this coverage as a legal pre-requisite for working within the profession or as a practical necessity. This form of insurance is most typically utilised in the fields of medicine, law, accounting and construction.

It should be noted, however, that the indemnity coverage must be directed solely to negligence-related professional claims as opposed to coverage against more serious charges (e.g. coverage against criminal fines). The latter limitation exists because the tax system should not be perceived as providing relief for criminal activity (see section 23(o) denying deductions per se for certain costs and fines relating to criminal activity).

IV. Effective date

The effective date is for taxable benefits derived by an employee during the employee's year of assessment commencing on or after 1 March 2011.

2.9. FURTHER REVISION TO EXECUTIVE SHARE SCHEME

[Applicable Provisions: section 8C, section 10(1)(k)(i) & section 64B(5)]

I. Background

Share and other equity-based incentive schemes (typically involving key employees) feature prominently in tax jurisprudence. Many of these schemes are initiated to convert the ordinary revenue nature of salary into capital gain. The essential nature of these schemes is to provide employees with a stake in the growth of their employer company (e.g. by having a stake in a specified number of shares or through phantom share schemes). Section 8C (enacted several years ago) is the latest attempt by Government to prevent this artificial conversion of ordinary into capital.

Unlike many anti-avoidance provisions, section 8C seeks to defer (rather than accelerate) taxation. More specifically, section 8C generally seeks to trigger taxation only when an employee effectively cashes out the employee's stake in the employer or effectively has the freedom to cash-out when desired. Taxation under section 8C seeks to preserve ordinary treatment for growth-related salary as opposed to artificial characterisation as capital. Vertical notions of equity require executives to pay tax on their earnings at top marginal rates as opposed to a maximum 10 per cent capital gain rate.

II. Reasons for change

While section 8C appears to be having the impact desired in the main, certain anomalies exist that may detract from the core principles section 8C seeks to achieve. These anomalies appear to exist in three areas: (a) company distributions in respect of restricted equity shares, (b) restricted share swaps, and (c) connected person transfers back to employers.

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Some circumstances wrongly accelerate ordinary revenue treatment while others wrongly defer the same.

III. Proposal

A. Distributions

1. Current law

Holders of shares qualifying as restricted equity instruments may receive distributions in respect of their shares during the period of restriction. These distributions may come in the form of dividends or as a capital distribution.

Capital distributions in respect of shares generally give rise to capital gains. However, if a taxpayer receives a capital distribution arising from a restricted equity instrument, the distribution is treated as ordinary revenue. Dividends in respect of shares (restricted or otherwise) are exempt in the hands of the holder and generally subject to the Secondary Tax on Companies.

2. Proposal

The treatment of capital distributions and dividends in respect of restricted shares will be aligned to one another. Both events will generally trigger ordinary revenue (and no Secondary Tax on Companies) in recognition of this partial cash-out. However, if the capital distribution or dividend consists of another restricted equity instrument, the capital distribution or dividend will be treated as a non-event. The restricted equity instrument will then be taxed like any other restricted equity instrument falling under section 8C.

B. Rollover treatment for swaps

1. Current law

Taxpayers holding restricted equity instruments subject to section 8C may swap their instruments or other restricted equity instruments if the terms of the instruments so permit. Under current law, section 8C largely seeks to treat this form of swap as a non-event to the extent a restricted equity instrument is received in exchange (the receipt of other forms of consideration will trigger ordinary revenue). The restricted equity instruments received will be subject to section 8C just like the section 8C instruments surrendered. However, for this rollover treatment to apply, the restricted equity instrument received in exchange must be from the employer, an associated institution or by arrangement with the employer.

2. Proposal:

The trigger for section 8C rollover treatment in respect of restricted equity swaps needs to be adjusted more in align with the principles of section 8C. Generally, the issue is whether the employee-holder of the restricted equity instrument has a continuing direct or indirect stake in the employer (i.e. is motivated by the employer's profitability). Therefore, section 8C rollover treatment should apply as long as the new equity instrument received is of the same employer or associated institution. The employer's (or associated institution's) actual involvement is irrelevant. If the Hence, if two employees swap restricted equity instrument without employer involvement, section 8C rollover treatment will apply. On the other hand, a swap of restricted equity instruments originally issued by wholly independent employers will trigger ordinary revenue.

C. Acquisition by co-employees or directors

1. Current law

An employee must include in the employee's income for a year of assessment any gain or loss in respect of the vesting of a restricted equity instrument, if the instrument was acquired under one of the following circumstances:

By virtue of the employee's employment or office of director of any company or from any person by arrangement with the employer; or
By virtue of any other restricted equity instrument held by that employee.

2. Proposal

There is a strong possibility of collusion as it is extremely difficult to determine when an employee acquired a restricted equity instrument from a co-employee or director or from an employer directly. In light hereof, there is a presumption that there is an automatic inclusion in section 8C without regard to a factual test. Therefore, the roll-over treatment will apply if the new equity instrument is received from another employee or director of the same employer. It is presumed that the new equity instrument is acquired by virtue of employment.

IV. Effective date

Distributions: This rule will be deemed to come into operation on 1 January 2011 and applicable in respect of a capital distribution or dividends received by or accrued on or after that date

Share swaps: The revised direct and indirect swap rules will come into operation for acquisitions occurring on or after 1 January 2011.

Section 8C(5) anomaly: The technical correction will come into operation for restricted equity instruments acquired on or after 1 January 2011.

2.10 DISCONTINUATION OF STANDARD INCOME TAX ON EMPLOYEES (SITE) ADMINISTRATIVE PROVISIONS

[…]

I. Background

The Standard Income Tax on Employees (SITE) system is a component of the Pay as You Earn (PAYE) method of paying income tax and is in effect a final withholding tax levied on the first R60 000 of remuneration. The Standard Income Tax on Employees (SITE) was introduced in 1988 to limit the number of personal income tax returns filed annually, freeing up resources to deal with more complicated returns.

II. Reason for Change

The reasons provided for the elimination of the SITE system are the administrative sophistication and increased modernisation of tax collections systems; at the time of introduction, more resources needed to be freed up to deal with more complicated returns; and the fact that the tax threshold for taxpayers younger than 65 years is approaching R60 000. The 2010/11 income tax thresholds for individuals younger than 65 is R57 000 and for individuals 65 or older is R88 528.

Technological improvements have overtaken the need for the SITE system. The implementation of e-Filing for employees' tax returns now allows for taxpayers earning up to R120 000 per annum with a single employer and no additional income or deductions not to file an income tax return, although they are liable to register as taxpayers

III. Proposal

An important corollary announcement in the 2010 budget is that in the process of abolishing SITE, "administrative relief measures will be considered for low-income taxpayers with multiple sources of income".

The discontinuation of SITE will potentially result in an increased tax liability for some low-income taxpayers with more than one source of income. Therefore SITE will be phased out over a three year period in order to limit any potential hardship to such taxpayers.

The application and unintended consequences arising from the abolition of the SITE system can be illustrated by two individuals with the same aggregated total amount of multiple source income and one of these individuals having an income stream that breaches the tax threshold and the SITE ceiling. The 2010/11 tax threshold is R57 000 for those under 65 years. Currently, there would be an anomaly in the tax treatment with a tax benefit for the "site only" taxpayer.

Example 1 - multiple source income individuals (2010/11)

			A	B	C	Total
Person X	1	Income	42 000	52 000	54 000	**148 000**
No registration		SITE	-	-	-	-
		PIT				**-**
Person Y	2	Income	42 000	36 000	70 000	**148 000**
Registration		SITE	-	-	540	540
		PAYE			1800	1 800
		PIT				**16 940**
		Additional				**14 600**

In terms of the existing tax regime, person X will not be required to pay any form of taxation, whereas person Y will be liable for taxation of R16 940. Under the new rules, person X will be treated in the same manner as person Y. An obvious result of the discontinuation of SITE is an "immediate" hardship (at least in cash flow and added liabilities) for the multiple income source SITE only individual.

A phasing-out approach in implementing the discontinuation of the SITE system is recommended in order to ease and lighten the consequential burden for some low income individuals with more than one source of income / more than one job.

The illustration below is an example which considers one person with three income sources under current legislation and the anticipated consequence with the aggregation of the person's income after the phasing out of SITE.

Example 2 - old and new regime

			A	B	C	Total
Current	1	Income	39 000	58 000	40 000	**137 000**
No Registration		SITE	-	180	-	180
		PIT				**180**
"New"	2	Income	39 000	58 000	40 000	**137 000**
Aggregation		PAYE	-	180	-	180
		PIT				**14 400**
		Additional				**14 220**

Normal tax payable with phasing-out relief

- 1/3rd of the aggregated tax payable amount calculated will be payable in the 2011/12 tax year,
- 2/3rds of the aggregated tax payable amount calculated will be payable in 2012/13 tax year, and
- 3/3rds (the whole) of the aggregated tax payable amount calculated will be payable in the 2013/14 tax year.

The affected multi-source income earners will be liable to pay income tax for the first time, but at an initial reduced rate. This option seems to be the most feasible in terms of simplicity of systems design and equity.

The discontinuation of SITE has also highlighted a problem experienced by individuals with multi-source incomes that are separately below R60 000, but in aggregate, are above the R60 000 threshold. At the time of assessment, some of these individuals experience a cash flow problem as too little PAYE has been deducted in aggregate. Mechanisms to mitigate this cash flow problem through education or requiring some employers to deduct additional PAYE during the year will be explored

IV. Effective date

SITE to be phased-out over three years as from 1 March 2011.

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3. INCOME TAX: MISCELLANEOUS SPECIAL CIRCUMSTANCES AMENDMENTS

3.1. PROFESSIONAL SPORT SUBSIDISATION OF AMATEUR SPORTS

[Applicable Provisions: Section 125 of the Revenue Laws Amendment Act, 2007 (Act No. 35 of 2007), section 1 “gross income” definition,11E and 24E of the Income Tax Act]

I. Background

Under current law, amateur sports is treated as a public benefit activity that is exempt from income tax if undertaken by an approved public benefit organization (PBO). PBOs may also engage in public benefit and trading activities, the latter being taxable. Therefore, if a PBO engages in both amateur and professional sports, the amateur sports arm will be exempt while the professional sports arm will be taxed.

As a general matter, donations to amateur sport PBOs are not deductible. However, if a PBO has both a professional sports arm and an amateur sports arm, the professional arm is eligible to deduct the subsidisation of amateur sports. Given the fact that the deduction for subsidisation exists only for professional subsidisation of amateur sports within a single entity, the tax rules allow for a tax-free amalgamation of sporting bodies. This form of tax-free amalgamation was permitted only for a transitory period (i.e. until the close of 2009).

II. Reasons for change

Professional sport is ultimately dependent upon amateur sports to develop the next generation of skilled athletes and fans. Subsidisation may occur during the year in which professional sports income is earned. However, more often than not, professional sports income comes on an irregular basis with funds from prosperous years being used to cover the lesser years.

Even though the tax rules provide some rules to facilitate subsidization of amateur sports by professional sports, the current tax rules are too restrictive. The model of a single combined professional and amateur entity is too simplistic, especially considering that the model requires current amateur sporting costs to be subsidised by current professional sports income.

III. Proposal

A. Extended amalgamation window period

As discussed above, Government enacted a transitional window period to allow for the tax-free amalgamation of professional and amateur sports so as to promote subsidisation. The effective date for this form of amalgamation came to an end for “disposals” occurring on or before 31 December 2009.

Unfortunately, some sporting organisations have been unable to complete the amalgamation process within the prescribed window period due to unexpected internal and external problems. Therefore, all amalgamations of this kind have come to halt due to the lapsing of the window period.

In order to renew the process of amalgamations still outstanding, the window period will be extended to the close of 31 December 2012. Furthermore, the current wording refers to a ‘disposal’ that occurs on or before the effective date. This approach is too restrictive because the “disposal” relating to an amalgamation may occur over an extended period of time. Therefore, it is proposed that wording should focus on the “conclusion of agreements” occurring on or before 31 December 2012 (with subsequent disposals being freely permitted).

B. Subsidisation among entities

The current tax focus on single entity subsidisation of amateur sports by professional sports has proven to be unrealistic. While many amateur sports and professional sports organisations may seek to amalgamate for tax and other commercial reasons. Many other sports bodies may seek to remain independent while having one entity subsidise another. For instance, combining national and regional sports into a single entity is largely impractical.

In view of these concerns, it is proposed that the subsidisation model be extended. Under the revised model, cross-funding between similar sports entities will be allowed. In other words, the deduction for an entity carrying on a trade in sports is now available when the expenditure is: (i) for the development of sport (other than capital expenditure) within the same entity, or (ii) for another entity similarly engaged in sport (other than capital expenditure).

However, cross-funding among entities comes at a price. The receipt of this funding is automatically includible in income. The recipient entity can then deduction this amount if expended for the development and promotion of sport (or further shifted to another entity carrying on a trade in sport).

> **Example**
> **Facts:** National Sports Body (an association established in South Africa) transfers R100 000 to Regional Sports Body (another association established in South Africa). Regional Sports Body transfers R60 000 for amateur sports games under its direct control. Regional Sports Body transfers R40 000 to Local Sports Body (a public benefit organisation). Local Sports Body spends the full R40 000 on training amateur athletes.
>
> **Result:** The R100 000 transfer to Regional Sports Body is deductible by National Sports Body. Regional Sports Body has R100 000 of gross income, but the R60 000 and R40 000 transfers are fully deductible. Local Sports Body has R40 000 of gross income, but again this R40 000 is deductible.

C. Deductible reserves for the future development and promotion of amateur sport

As stated above, current legislation only allows a deduction for subsidies against direct current expenditure for the development and promotion of amateur sports. However, professional sports income comes in cycles. Large amounts of income are generated during particular years with lower amounts in other years (depending on the success of the teams and whether a tournament is held locally). Years with large inflows are accordingly used to fund the survival of the sport over the next several years. None of this multi-year funding is deductible despite the ultimate use of the funds for promotion and development of amateur sport.

In view of these concerns, it is proposed that an allowance be created to facilitate the reserve of funds for the future expenditure of promotion and development of amateur sport. Unexpended amounts are added back in the following year (and deducted again as reserves if still dedicated to future amateur sport).

IV. Effective date

Extended amalgamation window period: The proposed amendment will apply retrospectively from 1 January 2008.

Subsidisation among entities and Deductible reserves for the future development and promotion of amateur sport: The proposed amendments will apply retroactively for years of assessment ending on or after 1 January 2011.

3.2. CHARGE FOR TERMINATING OF SECTION 10(1)(d) ENTITIES

[Applicable Provision: Section 10(1)(d)(iii) & (iv) of the Income Tax Act]

I. Background

Section 10(1)(d) exempts miscellaneous entities from Income Tax. The first category of exemption covers: mutual loan associations, fidelity or indemnity funds, trade unions, chambers of commerce and local publicity associations. The second category of exemption covers companies, societies or associations established to promote common interests of a group of persons. All of the above organisations fall outside the scope and structure of the tax rules for public benefit organisations and clubs.

Conditions for approval in respect of the above section 10(1)(d) entities are outlined solely in regulation (Government Gazette No. 31614, dated 21 November 2008). Pursuant to these regulatory conditions, the founding document of these entities must comply with certain requirements relating to ownership, financial control, permissible activities and payment of employees.

II. Reasons for change

Public benefit organisations and clubs are subject to a special tax charge when these entities terminate and the funds flowing there from are transferred outside certain parameters (are not transferred to public benefit organizations, clubs, etc…). If this charge applies, the public benefit organisation or club at issue is deemed to have taxable income equal to the market value of remaining assets less liabilities (i.e. net asset value).

Section 10(1)(d) lacks any exiting tax charge of this nature for impermissible transfers. Regulatory authority exists only for approval criteria. These entities can accordingly shift terminating transfers to profitable use without penalty.

III. Proposal

It is proposed that an exit charge be levied against a section 10(1)(d)(iii) and (iv) entity that undertakes an impermissible transfer. This exit charge will mirror the exit charges for public benefit organisations and clubs (i.e. the section 10(1)(d)(iii) and (iv) entity will be deemed to have taxable income equal to the entity's remaining asset value less liabilities). Procedural rules for withdrawals of approval will also be added that match the current rules for public benefit organizations and clubs.

IV. Effective date

The proposed amendment will be effective for withdrawals of approval occurring on or after the date of Presidential promulgation.

3.3. SYNCHRONISING PBO, SECTION 10(1)(d) AND CLUB TERMINATIONS

[Applicable Provisions: Sections 10(1)(d)(iii) & (iv), 30(3)(iii), 30(6), 30A(2)(iii) & 30A(7) of the Income Tax Act; Section 10(1)(d)(iii)/(iv) Regulations]

I. Background

Public benefit organisations, section 10(1)(d)(iii)/(iv) organisations and clubs enjoy partial or complete exemption from income tax due to their non-profit motive. Some of these entities undertake a shared responsibility for the social and developmental needs of the country, thereby indirectly relieving financial burdens of the State. Others merely entail a sharing of expenses.

In view of the fact that assets of these non-profit entities enjoy partial or complete exemption, various rules exist to prevent the use of these assets for non-permissible purposes (e.g. general profit-making). In line with this purpose, entities of this kind are only allowed to transfer remaining assets upon dissolution or withdrawal of exemption to other entities that retain their partial or complete exempt status.

II. Reasons for change

The rules relating to permissible transfers upon entity dissolution or withdrawal of exempt status differ for public benefit organisations, section 10(1)(d)(iii)/(iv) entities and clubs. No rationale reason can be discerned for these differences. Differences also exist for dissolutions versus withdrawal of exempt status. Ideally, all of these transfers should be synchronized so that the flow of assets moves to exempt entities with a non-profit purpose that is at least equal to the non-profit purpose for which these entities were employed before the transfer.

III. Proposal

A. Overview

It is proposed that permissible transfers upon entity dissolution or withdrawal of exempt status should be synchronised. Firstly, the two sets of rules will be merged. Permissible versus impermissible transfers will no longer be part of the entry criteria for approval. These transfers will be an issue only upon entity dissolution or exempt status withdrawal with impermissible transfers triggering an exit charge at that time.

B. Ordering rules

Permissible transfers should generally flow according to the following ordering paradigm:

Highest non-profit purpose:	Public benefit organisations, three spheres of Government and parastatals)
Medium non-profit purpose:	Section 10(1)(d)(iii) and (iv) entities
Lowest non-profit purpose:	Clubs

More specifically, upon entity dissolution or withdrawal of exemption, public benefit organisations should be permitted to transfer assets to other public benefit organizations, the three spheres of Government or section 10(1)(cA)(i) parastatals. Section 10(1)(d)(iii)/(iv) entities should be permitted to transfer assets to other section 10(1)(d)(iii)(iv) entities, public benefit organisations, the three spheres of Government or section 10(1)(cA)(i) parastatals. Clubs should be permitted to transfer assets to other clubs, section 10(1)(d)(iii)(iv) entities, public benefit organizations, the three spheres of Government or to section 10(1)(cA)(i) parastatals.

IV. Effective date

The proposed amendment will be effective for transfers occurring on or after the date of Presidential promulgation.

3.4 DEDUCTIBLE DONATIONS TO TRANSFRONTIER CONSERVATION AREAS

[Applicable Provision: Section 18A(1C) of the Income Tax Act]

I. Background

Donations made by a taxpayer represent expenditure of a private and philanthropic nature and are accordingly not deductible as a general matter. However, a special dispensation exists for certain categories of donations. This dispensation allows deductible donations to be made to registered Public Benefit Organisations (PBOs) that conduct one or more public benefit activities as listed in Part II of the Ninth Schedule.

Deductible donations to transfrontier parks contain a number of additional restrictions that do not apply to donations made to other PBOs. Most of these restrictions seek to ensure that deductible donations are limited to funding activities within South Africa. Deductible donations to transfrontier parks are also subject to a sunset clause expiring on 31 March 2010.

II. Reasons for change

The sunset clause for deductible donations to transfrontier parks was enacted at a time (i.e. in 2002) when the rules for PBOs were very new and largely untested. In addition, deductible donations to transfrontier PBOs deviated from the norm in that donation's to environmental PBOs were not deductible.

Since the sunset clause's enactment, history has proven that transfrontier parks have been a success. Donations to environmental PBOs are also now deductible as a general matter. The only unique feature of transfrontier parks is their cross-border nature, but special safeguards already exist in this regard. Therefore, the continued need for a sunset clause in respect of deductible donations to transfrontier parks is questionable.

III. Proposal

It is proposed that the 31 March 2010 sunset clause be deleted. Deductible donations to transfrontier PBOs will now become a permanent feature of the Income Tax Act.

IV. Effective date

The proposed amendment will be effective to donations made on or after 1 April 2010.

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4. INCOME TAX: MISCELLANEOUS SPECIAL BUSINESS AMENDMENTS

4.1. ANTI-AVOIDANCE RULE TO PREVENT FINANCIAL INSTRUMENT MISMATCHES

[Applicable provisions: Section 23[K] of the Income Tax Act]

I. Background

In general, interest expense (and other finance-related charges) allocable to revenue-generating assets is deductible while interest expense allocable to non-revenue producing assets is not deductible. This principle is in line with the general deduction formula.

While the general deduction formula envisions direct tracing of expenses to taxable income, the Appellate Division in the *Commissioner of Inland Revenue v Standard Bank* decision deviates from this principle. In the *Standard Bank* case, the bank borrowed funds from customer deposits from which interest was incurred. The bank utilised depositors funds (and other funds derived from non-deductible sources) to generate revenue. Occasionally, the bank would invest in redeemable preference shares producing exempt dividend income. Because of the existence of this exempt preference share income, SARS disallowed a proportion of the interest deduction based on the proportional existence of the preference shares.

The court held that as a matter of commercial necessity the bank accepts all deposits that go into a common pool that constitutes a general fund used for all purposes. The bank’s expenditure by way of interest on borrowed funds is not aimed at any particular form of utilisation. The court also found that there was no sufficiently close connection between the bank’s payment of interest and its receipt of exempt preference dividends to warrant the conclusion that the payment constituted expenditure incurred in the production of exempt income inadmissible for deduction.

II. Reasons for change

Concerns exist that the principles established in the *Standard Bank* decision are being misused for tax avoidance purposes. Firstly, some taxpayers are wrongfully applying the decision by applying the principle beyond *de minimis* proportional exempt amounts. Some also rely on the decision even if the linkage between exempt-income and otherwise deductible expenditure is clear.

The *Standard Bank* decision on the inability to trace bank funding also appears outdated. Modern financial institutions actually undertake specific tracing of assets received for use in operations as well as the income generated as part of compliance with non-tax regulatory requirements and to maintain commercial understandings. Actual allocation and tracing of assets received from depositors and other investors is largely known at inception. Moreover, it is not uncommon for specialised units within financial institutions to have an investment mandated to invest certain portions of investor funds in specified ways.

III. Proposal

A. General rule

The proposal mainly seeks to ensure tighter control over mismatch schemes involving financial instruments (where the bulk of mismatch schemes have historically arisen). In a nutshell, the purpose of a mismatch scheme is to create a deduction for expenditure and mismatch that amount against exempt income without the tax system recognising the connection. The *Standard Bank* decision makes this mismatch proposition easier and hence must be overturned.

The proposed amendment achieves this result by imposing an overall reduction of otherwise allowable deductions in respect of financial instrument expenditure (as a starting presumption). This financial instrument expenditure mainly entails interest but also covers other financing expenditure (such as the payment of manufactured dividends and premiums to acquire options). Under the overall reduction formula, otherwise allowable deductions for all expenditures incurred in respect of financial instruments will be reduced as an aggregate. This aggregate reduction will apply to the extent that the taxpayer receives exempt amounts derived from financial instruments.

It should be noted that this aggregate reduction for otherwise deductible expenditures in respect of financial instruments does not apply to section 11(a) deductions incurred to acquire trading stock. Deductions of this nature are always matched by closing stock or gross income upon disposal.

Example
Facts: Bank incurs interest expenses of R6 million in respect of R100 million of deposits. During the same year, Bank generates R10 million of interest income from residential property and car loans totaling R90 million. Bank also generates R5 million of dividends from preference shares with a value of R10 million. Lastly, Bank holds ordinary shares worth R4.2 million that were acquired during the year at a cost of R3 million. The ordinary shares qualify as trading stock.

Result:
Trading stock exclusion: The R3 million cost to acquire the preference shares is not subject to potential reduction despite characterisation as section 11(a) deductions in respect of financial instruments. This R3 million falls outside the overall reduction because the expenditure represents the cost price of trading stock.
General rule: The R5 million of exempt dividends from the preference shares automatically reduces the R6 million of otherwise allowable interest deductions. The only way to escape this rule is through tracing relief as proposed.

B. Tracing relief

However, this aggregate reduction can be overcome through tracing. More specifically, exempt income from financial instrument will fall outside this reduction to the extent the taxpayer can prove that the financial instrument was funded solely from amounts other than amounts derived from a loan, debt, obligation or other similar arrangement (whether contingent or otherwise) in respect of which an expenditure is incurred by the taxpayer. In other words, taxpayer will now have an affirmative duty to prove that the source of funding in respect of financial instruments producing exempt income does not come from financial instruments causing a mismatch. Without this proof, the general reduction applies. This form of tracing is determined in an instrument-by-instrument basis.

The proposed denial focuses on actual application (i.e. funding) as opposed to purpose (the core focus of the general reduction formula). Given the resultant nature of this test, the reduction occurs only once the exempt income is received or accrued. The intention to incur a deduction for the production of exempt income should have already resulted in a denial. This denial protects the fiscus against actions that ultimately differ from the initial production of income intent.

Example
Facts: Holdco owns equity in Subco. The subsidiary company (Subco) declares dividends to Holdco, which places the proceeds received in a separate bank account. Holdco uses part of the proceeds received to acquire more shares in Subco, with the balance used to purchase preference shares in the market.

Result: Taking into account the reduction rules, a limitation on the deduction would apply as per the aggregate reduction rule. After taking into account the new tracing rules, a reduction of interest deductions would take place as the preference shares were bought using the exempt proceeds.

IV. Effective date

The proposed amendment will be effective for expenditures and losses incurred in respect of years of assessment beginning on or after 1 January 2011.

4.2. IMPROVEMENTS ON GOVERNMENT LAND

[Applicable provisions: 11(g) 11D, 12D, 12DA, 12F, 12I, 13, 13bis, 13ter, 13quat, 13quin, 13sex, 36, and the new 12N of the Income Tax Act]

I. Background

An Income Tax allowance exists for expenditure actually incurred by a lessee for obligatory improvements undertaken on leased land or buildings. The amount of the allowance is generally equal to the amount of the expenditure divided by the lease period (or 25 years if sooner). If the allowance is not fully exhausted by the termination of the lease, the remaining amount is deductible by the lessee upon lease termination.

However, the allowance is not available if the lessor is tax exempt unless the improvement is undertaken:

- in terms of a Public Private Partnership, or
- on land owned by government (national, provincial or local) by an exempt government controlled body if the land is leased for a period of at least 20 years.

II. Reasons for change

The general denial of the improvement allowance in respect of leased land or buildings of an exempt lessor was enacted in the early 1980's to prevent tax avoidance. At that time, a number of lease financing schemes existed so that financiers could obtain artificial write-offs for improvements on leased property as if these financiers had directly owned and operated the underlying property. These schemes were particularly prevalent in the case of municipalities (or other exempt parties seeking finance) because these entities lacked a tax base from which depreciation allowance could be utilised. The purpose of the lease finance schemes was to shift the depreciation allowance to financiers that had a tax base upon which the allowance could be utilised.

The artificial shifting of depreciation allowances from exempt persons to taxable persons remains of concern. On the other hand, the general prohibition of depreciation allowances in respect of improvements undertaken by lessees of government-owned property runs contrary to Government policy. The three spheres of Government (as well as certain Government-owned institutions) enter into various arrangements to provide underlying land with the private sector constructing buildings or improvements thereto. These arrangements are necessary because the three spheres of government (and certain parastatals) sometimes lack the cash funds to directly undertake this desired construction (as a matter of policy these spheres of government often prefer not to permanently part with ownership of the underlying land).

In view of these concerns, a straight-line write off was allowed for improvements in the case public private partnerships and in the case of government-owned land (as long as the lease period lasted at least 20 years). However, this write-off is sometimes less favourable than write-offs in the case of improvements made to directly-owned land. For instance, the owner of land within an urban development zone can write-off a building or improvement at an accelerated rate (e.g. five years in the case of improvements and 17 years in the case of new buildings). This accelerated write-off is unavailable to lessees undertaking improvements in the case of an exempt government lessor.

III. Proposal

A. *Revised depreciation allowance*

Qualifying criteria

The new depreciation rules will apply to obligatory improvements undertaken on property in the case of public private partnerships, the three spheres of government and certain exempt parastatals. Furthermore, the lessee should use the property for purposes of earning income therefrom e.g. rental income from the building.

Application

The current straight-line regime will be replaced. Obligatory improvements by lessees in these circumstances will be eligible for a depreciation allowance as if the lessee owned the underlying property directly (lessee will be deemed to be the owner). The net effect of this change is to allow for accelerated write-offs to the extent these accelerated write-offs are allowed for owned property e.g. for purposes of sections 12D, 12F, 13ter, 13quat, 36, etc. Where it is required that the improvement be new and unused, the new provision deems the improvement by the lessee to be new and unused with the expenditure being deemed to be the cost of that improvement.

If an improvement has not been fully written off by lease termination, any remaining cost can be written off by the lessee at that time. However, a lease will be viewed as not terminating if the lessee is obligated to renew, holds a right or option to renew or is reasonably likely to renew as of the date on or immediately before the date of termination.

The new depreciation allowance for improvements made on leased property will not apply in the case of financial leases. More specifically, the lessee must not generally sublease the property. Subleases will be permitted only if the improvement is leased to the general public for a period of not more than one-year at a time, the cost of maintenance and repair is borne by the lessee and the potential risk of destruction or loss is borne by the lessee. It will also not apply where the lessee carries on banking, financial services or insurance business.

Example 1
Facts: Company X enters into a contract with the Municipality in terms of which the Municipality leases a building to Company X to undertake business activities. It is agreed that Company X would effect improvements on the building to the tune of R100 000, which Company X promptly does. The building is situated on a piece of land that is located in a designated urban development zone.

Result:: Although Company X is not the actual owner of the land in which the building is constructed, nor is Company X the owner of the building, the new provisions deem Company X to be the owner of the building. Therefore, Company X will be able to depreciate the building in terms of the accelerated depreciation regime for property located within an urban development zone. Thus, Company X will be eligible for a 20% per annum depreciation of the building.

Example 2
Facts: A Provincial government leases land to a Bank. The Bank constructs an office apartment to the tune of R20million in terms of the lease agreement. The Bank leases the office apartment to the Provincial government.

Result: The Bank will not be allowed to depreciate the value of the office apartment as it is sublet to the Provincial department.

B. *Collateral changes*

The straight-line write off for improvements in the case of underlying property leased by public private partnerships, the three spheres of government and certain exempt parastatals will be eliminated. The new regime will become the exclusive write for these circumstances.

As a collateral matter, the current straight-line write off for improvements needs to be adjusted for more basic considerations. For instance, the write-off needs to be more in line with the lease premium rules (i.e. to extend the lease period for rights or options to renew). Certain obsolete rules also need to be modified.

IV. Effective date

The amendment applies in respect of expenditure incurred in respect of leases entered into on or after the date of promulgation (i.e. 1 October 2010).

4.3. ISLAMIC FINANCING

[Applicable provision: New Section 24JA to be inserted in the Income Tax Act section 8A; VAT and section 3A Transfer Duty]

I. Background

Islamic finance signifies financial services, transactions and instruments that comply with Shari'a or Islamic law. Islamic finance is based on certain principles that impact transactional form, including:

- The prohibition of riba (interest);
- The prohibition of gharar (i.e. the removal of asymmetrical information from contracts and the encouragement of full disclosure);
- Risk-sharing (i.e. sharing profit or losses); and
- Materiality (i.e. financial transactions must be linked to a real economic transaction).

Islamic finance is still in its infancy within South Africa. The Islamic products offered by the South African banking industry are still fairly new and fairly diverse. South African collective schemes are also just entering the market. Some of the more common forms of Shari'a compliant products within the South African market are as follows:

1. Mudarabah: The Mudarabah is mostly used as an investment or transactional account offered to clients. More specifically, the client deposits savings in an account with a bank (or a collective investment scheme). The bank (or collective investment scheme) invests the funds in Shari'a compliant ventures or products. The profits from the underlying Shari'a compliant ventures or products offered by the bank (or collective investment scheme) are shared with the client at a pre-agreed ratio. The client bears all the risk of financial losses and the bank (or collective investment scheme) bears operational losses (e.g. management fees).

2. Murabaha: The Murabaha is a mark-up financing transaction generally offered by bank so that a client can obtain financing for various assets (fixed property and equipment). In this form of financing, the bank purchases an asset (from a third party) at the instruction of the client and sells the asset to the client at a pre-agreed price. The mark-up on the resale by the bank creates a profit for the bank, and this profit is calculated with reference to the time value of money. The client pays the marked-up price on a deferred basis (similar to an installment sale agreement). The marked-up price cannot be altered at any point after the initial agreement is concluded.

3. Diminishing Musharaka: Diminishing Musharaka is a partnership arrangement generally used for project financing. The client and the bank jointly acquire various assets. The Bank's share in the asset is further divided into smaller units. The bank and the client enter into another agreement in terms of which the client undertakes to purchase the bank's proportionate interest over time through the periodic purchase of individual units. The bank also earns rent from its proportionate interest in the asset. This rent comes from the client and diminishes over time as the bank's proportionate interest in the asset diminishes.

III. Reasons for change

As a general matter, the starting point for determining the tax consequences of any transaction is form. While the tax acts provide both statutory and common law principles in certain instances to overcome this starting presumption, these substance-over-form rules are largely employed to protect the fiscus against avoidance transactions. Few rules exist to overcome form for the benefit of taxpayers because taxpayers largely have control over form.

However, the concept of form in the arena of Shari'a compliant products largely works against taxpayers because taxpayers lack this full freedom of control as a result of religious principles. These deviations in form often deprive investors of certain benefits available to traditional western finance. In other instances, Islamic form can actually act as a tax barrier to tax cost-effective finance that can readily be performed by western counterparts.

Given these concerns, tax has become a hindrance to a vibrant and growing Islamic financial market. This lack of access not only prejudices Islamic finance but also work against South Africa's financial role in non-Western markets, thereby undermining South Africa as a regional financial centre. From a tax policy vantage point, it is also questionable whether Islamic forms of finance should be treated differently than their western counterparts when the substance is largely the same.

III. Proposal

A. Overview

It is proposed that specific provisions be added to the various tax acts so that Islamic finance is placed on equal footing with traditional western finance. Given the diversity of Islamic finance, the current proposal focuses on certain more commonly used *Shari'a* compliant arrangements within South Africa. At this stage, the following three arrangements will be covered: (i) Mudaraba, (ii) Murabaha, and (iii) Diminishing Musharaka

B. Mudarabah

1. Tax relief for individual savings

The Mudarabah acts like a partnership in form and in substance while the yield is roughly comparable to interest. Partnership sharing of profits in unequal proportions is not uncommon. What is unique about the Mudarabah form of financing is client access to *Shari'a* underlying compliant profits (usually mirroring interest). This form of relationship is also the most common mechanism that banks and collective investment schemes use to access retail investors.

Given this purpose, any profit earned by natural persons in terms of a Mudarabah arrangement will be deemed to constitute "interest" for the purposes of the basic interest exemption for individuals. The individual client will therefore receive the same threshold interest exemptions as their western counterparts investing in interest-yielding products. At the present time, the exemption amounts to R22 300 for individuals under age 65 and to R32 000 for individuals age 65 and older.

2. Qualification criteria

In order for the bank (or collective investment scheme) to offer tax qualifying Mudarabah, the savings or investment arrangement must satisfy the following requirements:

- The arrangement must be offered by a bank (or collective investment scheme) to the general public;

- The natural person and the bank (or collective investment scheme) must share in the profits derived from *Shari'a* compliant arrangements on a pre-agreed basis;

- The client must incur the sole risk of loss in respect of the deposit or contribution into the *Shari'a* compliant arrangement; and
- The profit sharing ratio must not be varied during the life of the arrangement;

- The arrangement must be advertised to the general public as an arrangement that is compliant with *Shari'a* law;

C. Murabaha

1. Borrowed funds equivalence

The substantive impact of the Murabaha mark-up can readily be recharacterised as traditional interest. This resale mark-up by a bank is based on time-value principles amounting to interest generated for the bank and interest incurred by the client. In essence, the client is acquiring property from a third party seller with the bank acting as agent (and lender) to facilitate the transaction without violating Islamic law. More specifically, bank offered Murabaha will be recharacterised as described below for purposes of Income Tax, Value-added Tax and Transfer Duty.

Income Tax

For purposes of the Income Tax Act, bank offered Murabaha will be deemed to have the following impact:

i. The bank is deemed not to be involved with the purchase or sale of the property. This treatment means that the bank is deemed not to have acquired or disposed of the property that is the object of the Murabaha arrangement.

ii. The client is deemed to be acquiring property directly from the seller: *(a)* for an amount equal to the consideration payable by the bank to the seller, and *(b)* to have acquired the property at the time that the seller disposes of the property.

iii. The mark-up by the bank is deemed to be interest. Technically, to achieve this result, the Income Tax Act will deem the Murabaha arrangement as a whole to qualify as a section 24J "instrument", the mark-up to constitute a "premium payable or receivable" (thereby qualifying as section 24J "interest"), and the bank consideration payable to the seller to constitute the "issue price" (thereby being taken into account as a section 24J "initial amount").

Value-added Tax

For purposes of the Value-added Tax Act, bank offered Murabaha will be deemed to have the following impact:

i. The bank is deemed to be acting as an agent of the client (i.e. the client is deemed to be the principal and acquires the asset directly from the third party seller) so as to avoid the partnership treatment. This treatment means that the bank is deemed not to have acquired or supplied the property that is the object of the Murabaha arrangement.

ii. The client is deemed to be acquiring property directly supplied by the seller: *(a)* for an amount equal to the consideration payable by the bank to the seller, and *(b)* to have acquired the property at the time that the seller supplies the property.

iii. The mark-up by the bank is deemed to be interest. Interest treatment means that the mark-up is deemed to be (an exempt) financial service. However, financial service treatment will not apply to the extent the bank is providing management services (instead of interest-bearing capital).

Transfer Duty

For purposes of the Transfer Duty, bank offered Murabaha will be deemed to have the following impact:

i. The bank is deemed not to be involved with the purchase or sale of the property. This treatment means that the bank is deemed not to have acquired the property that is the object of the Murabaha arrangement.

ii. The client is deemed to be acquiring property directly from the seller: *(a)* for an amount equal to the consideration payable by the bank to the seller, and *(b)* to have acquired the property at the time that the bank acquires the property from the seller.

iii. The mark-up by the bank is deemed to be a “premium payable” by the client. This mark-up has no relevance for purposes of the Transfer Duty.

Example
Facts: Individual identifies a printing machine from an equipment dealer. Individual then approaches Bank for Murabaha finance. Bank agrees to purchase the equipment for R9, 000 in its own name and to on-sell the equipment to Individual at R17, 000, the amount of which is payable by Individual in one lump sum at the end of a 24 month period. Bank acquires the printing machine on 5 June 2011, and Individual acquires the printing machine from Bank on 12 June 2011.

Result: The Murabaha financing arrangement has the following impact:

<u>Income Tax</u>
• For income tax purposes, Individual is deemed to have directly acquired the printing machine directly from the dealer at a cost of R9 000 on 12 June 2011. Bank is deemed not to have acquired or disposed of the printing machine.

• The marked-up amount of R8 000 (i.e. R17 000 less R9 000) constitutes a “premium payable” by the client. The R8 000 mount constitutes an accrual amount in favour of the Bank for section 24J purposes.

<u>Value-added Tax</u>
• For value-added tax purposes, Individual is deemed to have directly acquired the printing machine directly supplied from the dealer at a cost of R9 000 on 12 June 2011. Bank is deemed not to have acquired or disposed of the printing machine.
• The R8 000 mark-up is deemed to be an exempt financial service offered by the Bank. Note: If the R8 000 includes a management/administrative fee, this will fall outside financial service treatment.

2. Qualification criteria

In order for natural persons to access finance in respect of the Murabaha, the arrangement must satisfy the following requirements:

- The product (i.e. the arrangement”) must be offered by a bank to the general public;

- The asset must be purchased by the bank from a third party based on terms and conditions agreed upon between the client and that third party;

- The bank must have a right to repossess the asset on default of any payment due by the client in terms of the arrangement;

- The bank must acquire the asset on condition that the client will acquire the asset from the bank at a pre-determined cost higher than the cost to the bank of acquiring the asset from the initial seller;

- The client will pay the purchase price of the asset in more than one instalment from the Bank; and

- The profit mark-up charged by the bank to the client should not be varied during the life of the arrangement;

- The acquisition by the client must occur within 180 days after the acquisition by the bank.

- The product (i.e. the arrangement") must be advertised to the general public as an arrangement that is compliant with *Shari'a* law;

D. Diminishing Musharaka

1. Borrowed funds equivalence

The substantive impact of the Musharaka joint purchase/cross purchase can readily be recharacterised as traditional interest. Assuming the client purchases proportionate interests form the bank at bank cost, the rent paid to the bank is equivalent to interest. In essence, the client is acquiring property from a third party seller (as a down-payment) with the bank acting as agent (and lender) to facilitate the transaction without violating Islamic law. More specifically, bank offered Murabaha will be recharacterised as described below for purposes of Income Tax, Value-added Tax and Transfer Duty.

Income Tax

For purposes of the Income Tax Act, bank offered Diminishing Musharaka will be deemed to have the following impact:

i. The bank is deemed not to be involved with the purchase or sale of the property. This treatment means that the bank is deemed not to have acquired or disposed of the bank's proportionate interest in the property that is the object of the Diminishing Musharaka arrangement.

ii. The client is deemed to be acquiring the banks proportionate interest in the property directly from the seller: *(a)* for an amount equal to the consideration payable by the bank to the seller, and *(b)* to have acquired the proportionate interest at the time that the seller disposes of the interest to the bank.

iii. The rent is deemed to be a "premium payable". Technically, to achieve this result, the Income Tax Act will deem the Diminishing Musharaka arrangement as a whole to qualify as a section 24J "instrument", the rent to constitute a "premium payable or receivable" (thereby qualifying as section 24J "interest"), and the bank consideration payable to the seller to constitute the "issue price" (thereby being taken into account as a section 24J "initial amount").

Value-added Tax

For purposes of the Value-added Tax Act, bank offered Diminishing Musharaka will be deemed to have the following impact:

i. The bank is deemed to be acting as an agent of the client in respect of the bank's proportionate interest (i.e. the client is deemed to be the principal and acquires the proportionate interest directly from the third party seller) so as to avoid partnership interest. This treatment means that the bank is deemed not to have acquired or supplied the bank's proportionate interest in the property that is the object of the Diminishing Musharaka arrangement.

ii. The client is deemed to acquire the bank's proportionate interest in the property directly as a supply from the seller: *(a)* for an amount equal to the consideration payable by the bank to the seller, and *(b)* to have acquired the proportionate interest at the time that the seller disposed of the interest to the bank.

iii. The rent is deemed to be interest. Interest treatment means that the rent is deemed to be (an exempt) financial service. However, financial service treatment will not apply to the extent the bank is providing management services (instead of interest-bearing capital).

Transfer Duty

For purposes of Transfer Duty, bank offered Diminishing Musharaka will be deemed to have the following impact:

i. The bank is deemed not to be involved with the purchase or sale of the property. This treatment means that the bank is deemed not to have acquired the bank's proportionate interest in the property that is the object of the Diminishing Musharaka arrangement.

ii. The client is deemed to be acquiring the banks proportionate interest in the property directly from the seller: *(a)* for an amount equal to the consideration payable by the bank to the seller, and *(b)* to have acquired the proportionate interest at the time that the seller disposed of the interest to the bank.

iii. The rent received or accrued by the bank effectively operates as interest. This rent has no relevance for purposes of the Transfer Duty.

Example

Facts: Individual identifies a residential property worth R1 million and approaches the Bank for finance through the use of Diminishing Musharaka. Bank agrees to purchase property jointly with the Individual from the seller on condition that:

- Individual pays 20 per cent (i.e. R 200 000) of the purchase price and the Bank pays 80 per cent (i.e. R800 000);
- Individual will purchase 10 per cent of the Bank's proportionate interest in the property each year over a period of 8 years for R100 000 per year, and
- Individual pays an annual rental of R96 000 for the right of occupation in the Bank's proportionate interest in the residential property.

Result:

Income Tax

- For income tax purposes, Individual is deemed to have directly acquired the residential property directly from the dealer at a cost of R1 million. Bank is deemed not to have acquired or disposed of the residential property.
- The Individual is also deemed to have acquired the property directly from the seller at a cost of R1 000 000. The R800 000 constitutes the issue price of the instrument. The Bank is deemed not to have acquired or disposed of the property.
- The annual rental of R96 000 constitutes the premium payable by the client and an accrual amount in favour of the Bank for purposes of section 24J.

Transfer Duty

- For Transfer Duty purposes, Individual is deemed to have directly acquired the residential property directly from the seller at a cost of R1 million.
- The rent has no impact on the Transfer Duty.

2. Qualification criteria

In order for natural persons to access finance in respect of the Diminishing Musharaka, the arrangement must satisfy the following requirements:

- The product (i.e. the arrangement") must be offered by a bank to the general public;
- The bank must acquire the asset jointly with the client;
- The client must agree to purchase all of the bank's proportional interest in the asset over time;
- The purchase price of the bank's proportional interest by the client must be equal to the consideration paid by the bank to the initial seller for the bank's proportional interest;
- The client must pay rent to the bank in respect of the bank's proportionate interest in the asset; and
- The product (i.e. the arrangement") must be advertised to the general public as an arrangement that is compliant with *Shari'a* law;

IV. Effective date

The proposed amendment will be effective from a date to be announced by the Minister.

4.4. TERMINATING COMPANIES AND SMALL/MICRO BUSINESS RELIEF

[Applicable provisions: Section 12E(4)(a)(ii), section 12E(4)(d) & paragraph 3(f) of the 6th Schedule of the Income Tax Act]

I. Background

Special income tax dispensations exist for small business companies and micro businesses. In the case of certain micro businesses, taxpayers may elect a simplified turnover basis of taxation in lieu of normal income tax. In the case of certain small business companies not utilising the turnover basis of taxation, a graduated tax structure applies (0%, 10% and 28%) in lieu of the standard 28 per cent rate and immediate 100 depreciation is available for certain assets.

A key precondition common to both dispensations is the anti-multiple shareholder rule. The anti-multiple shareholder rule is designed to prevent small businesses from obtaining relief by splitting a single large (ineligible) business into multiple small (qualifying) businesses. More specifically, businesses are denied relief for a particular business under both dispensations if the ultimate owners hold equity in any other company at any time during the relevant year of assessment.

II. Reasons for change

By 2009, it became apparent that the existence of certain dormant shelf companies was hindering small business company or micro business relief due to the anti-multiple shareholding rule. From a practical perspective, this problem arose because the seller of a dormant shelf company usually holds shares in many other dormant shelf companies (i.e. shelf-company sellers typically hold dormant shelf companies on hand for sale). The anti-multiple shareholding rule was accordingly suspended in these commercially-driven circumstances.
During the 2009 hearings, some commentators argued that the anti-shareholder prohibition should also be dropped if the company at issue had taken steps to terminate but remained in existence solely due to regulatory reasons outside of taxpayer control. This set of circumstances was effectively viewed as commercially driven, much like the shelf-company circumstances.

III. Proposal

Connection (e.g. ownership or some other form of connected person relationship) to a terminating company will no longer be grounds for preventing small business company and micro business relief. In order for a terminating company to be excluded in this manner, the terminating company must have either: (i) submitted a resolution authorising the voluntary liquidation or winding up of the company, or (ii) submitted a statement of deregistration. In the case of a liquidation or wind up, no assets and liabilities must exist in relation to the terminating company (other than residual assets to pay certain regulatory or administrative liabilities). In the case of a de-registration, the terminating company must have ceased business and have no assets or liabilities.

Admittedly, circumstances may arise that may cause a desired revival of the terminating dormant company. If steps are taken to revive a terminating dormant company, the connected small or micro business will lose the relief from the year of assessment in which revival occurs (and onward). No special recoupment or other retrospective charge backs will be required.

Example 1

Facts: Individual owns Company X, which has run into economic trouble. Individual accordingly begins to shut down the business and reduce business assets and corresponding liabilities. In 2011, Individual forms Company Y to start a new business venture.

Result: Assuming Individual and Company X have taken appropriate steps to terminate before the 2011 year of assessment, Company Y will not be prevented from claiming small business company or micro business relief due to the anti-multiple shareholding rule. In other words, Company X can be disregarded for this purpose.

Example 2
Facts: The facts are the same as Example 1, except that a new business opportunity becomes available for the former Company X operations. Individual accordingly takes steps to revive Company X in 2015.

Result: The anti-multiple shareholder rule will apply from the 2015 year of assessment onward. Hence, Company Y will lose the ability to claim small business company or micro business relief from this year onward. No recoupment or charge backs will be required for any relief claimed between 2011 through 2014.

IV. Effective date

This provision will apply to small business companies and micro businesses for years of assessment commencing on or after 1 January 2011.

4.5. CORPORATE REORGANISATIONS INVOLVING PLANTATIONS

[Sections 41(1) & (7) & 42 of the Income Tax Act and Paragraphs 14(1) of the First Schedule to the Income Tax Act]

I. Background

A. Character of plantations

Plantations receive a tax preference (like mining). All of the expenditure incurred by a farmer in establishing, maintaining or acquiring the plantation is immediately deductible, subject to a ring-fencing of losses. However (like mining), this incentive comes at a price. All proceeds from the disposal of a plantation are included in gross income, not just the prior amount allowed as a deduction.

Most plantations are capital in nature by virtue of the common law. However, as discussed above, all amounts received or accrued from the disposal of plantations are included in gross income (and are deemed not be of a capital nature). This automatic gross income treatment results in plantations being treated as trading stock without regard to the common law.

B. Plantations and corporate reorganisations

The Act provides roll-over relief for assets (i.e. as trading stock, as a capital asset and/or as an allowance asset) transferred as part of a company reorganisation. This roll-over relief defers gains, recoupments and gross income otherwise realised. Rollover treatment also deems the transferor and transferee to be one and the same person in relation to any allowances and deduction which may be claimed by the transferee in respect of the assets transferred.

II. Reasons for change

A. Character of plantations

The treatment of plantations as trading stock (whether by virtue of the deeming rules or by virtue of the common law) is problematic in the context of the reorganisation rules. Company reorganisation roll-over relief for trading stock hinges on the closing stock and opening stock adjustments associated with that trading stock.

This focus on closing and opening stock, however, is ineffective for plantations treated as trading stock. Because plantations are fully deductible upon acquisition, establishment and maintenance and fully includible upon disposal, plantations simply do not have closing and opening stock adjustments. Plantations operate more like allowance assets.

B. Plantation recoupments

The non-recoupment rule for allowance assets applies only to the extent of prior allowances. This relief is only partially effective for plantations because the inclusion of proceeds from the disposal of plantations does not bear any relation to prior allowances or deductions.

III. Proposal

A. Character of plantations

Plantations will no longer be treated as trading stock per se despite the realisation of gross income upon disposal. The common law distinction between capital and revenue will prevail for general purposes of the Income Tax Act (while receipts and accruals will remain gross income). In addition, plantations will always be treated as allowance assets for purposes of the company reorganisation rules. The latter treatment will simplify company rollover relief for plantations.

B. Plantation recoupments

The non-recoupment rule for allowance assets will be put on par with mining capital expenditure. All gross income associated with the plantations will be deferred, even if that gross income exceeds the prior deduction.

IV. Effective date

The amendment is applicable to transactions occurring on or after the date of promulgation (01 October 2010).

4.6. TRACING WAIVER IN THE CASE OF SHARE-FOR-SHARE LISTED COMPANY REORGANISATIONS

[Applicable provisions: Section 42(1)(b), (2)(b), (2)(bA)]

I. Background

The Income Tax Act contains various roll-over provisions designed to defer gain when corporate entities reorganise. In listed share-for-share reorganisations, relief is granted to transactions involving the disposal of target company shares by one or more target shareholders to an acquiring company in exchange for newly issued acquiring company shares. In a listed context, the target company, the acquiring company or both may be listed on the JSE.

The rollover nature of the relief generally implies that the acquiring company acquiring the target company shares obtains the same (i.e. rolled-over) tax cost in the shares as previously held by the target shareholders. However, if an asset is acquired by a listed company in a company reorganisation, the tax cost of the asset in the hands of the listed acquiring company is the market value of the asset (i.e. as if the asset were acquired by the acquiring company for cash). This deviation from the roll-over of tax cost exists because the acquiring company cannot be realistically expected to know the tax cost of the target shares held by the target shareholders in a listed context.

II. Reasons for change

The rollover rules for share-for-share reorganisations contain a number of requirements. One requirement is that the asset (i.e. the target shares transferred) must generally be acquired by the acquiring company in the same character as held by the transferor (i.e. the target shareholder surrendering the shares). In other words, if the target shareholder holds the target shares as trading stock before the reorganisation, the acquiring company must hold the target shares as trading stock immediately afterwards.

While essential to prevent certain forms of anti-avoidance, the requirement that the transferee company should acquire the asset in the same character as the transferor can be problematic. It is practically impossible for the transferor to ascertain or trace the character in which a wide array of target shareholders holds shares in a listed context. In essence, the same practical problem exists in this instance as existed for determining the tax cost of the target shares held by the target shareholders before the listed market value was introduced.

Furthermore, while the market value rule for tax cost provides necessary relief for listed share-for-share transactions, the threshold requirements for this relief is not entirely appropriate. At the present stage, one of the key threshold requirements is for the acquiring company to be listed; whereas, the problem of tracing really only exists if the target company is listed (i.e. has a wide array of shareholders).

III. Proposal

A. General overview

In view of the above, a unified special regime for listed share-for-share reorganisations is proposed that covers both the character tracing problem as well as the rollover tax cost tracing problem. The trigger for these relief mechanisms will be adjusted so that the criteria more closely fit the practical problem.

B. Revised rules

The listed requirement will henceforth be based on the status of the target company as opposed to the acquiring company. More specifically, relief will apply if the target company is listed but only for target shareholders not holding more than 20 per cent of the target company before the transaction. Moreover, the relief applies only if the acquiring company obtains a controlling interest in the target company as a result of the reorganisation. At the end of the share-for-share transaction, the acquiring company must generally hold at least 35 per cent of the shares in the listed target company. This threshold can be reduced to 25 per cent if no other shareholder holds an equal or greater shareholding in that target company as held by the acquiring company. These control requirements stem from the previous share-for-share reorganisation rules, which were subsequently merged into the asset-for share reorganisations several years ago (i.e. previously contained in section 43).

If the relief criteria apply, the requirement that the transferee company must generally acquire the target shares in the same character as the transferor will be eliminated. As a result, the acquiring company can hold the target shares as trading stock or as capital without regard to the previous target shareholders. The tax cost of the target company shares in the hands of the acquiring company will remain at market value (as under prior law for listed reorganisations). Thus, in the listed context, the acquiring company again does not step into the shoes of the target shareholder. The acquiring company instead treats the expenditure as if acquired for cash (resulting in a market value tax cost and a date for the acquisition of the shares being the date on which the reorganisation was entered into).

Example

Facts:

Before the share-for-share reorganisation: One million shareholders hold the shares of Company 1 worth R100 million (and have an aggregate tax cost of R20 million in those shares). Three million shareholders hold the shares of Company 2 worth R300 million. Company 1 and Company 2 are both listed companies, and no shareholder holds more than 5 per cent of the shares in either company.

Impact of the share-for-share reorganisation: The target shareholders transfer all of their shares in Company 1 to Company 2 in exchange for newly issued Company 2 shares. This transfer occurs pursuant to a share-for-share reorganisation in terms of Section 42. Upon completion, Company 1 will be wholly owned by Company 2.

Result: The former one million target shareholders have a tax cost of R20 million in their newly received Company 2 shares. Company 2 has a tax cost of R100 million in the Company 1 shares. In determining whether the transaction qualifies as a section 42 transaction, no regard is had as to whether the target shareholders previously held shares as trading stock or capital.

IV. Effective date

This provision will apply to transactions entered into on or after promulgation date (i.e. 1 October 2010).

4.7 DEFAULT ELECTIONS INVOLVING INTRA-GROUP ROLLOVERS

Section 45(4)(b)(ii) of the Income Tax Act

I. Background

The Income Tax Act provides for a roll-over relief for assets transferred in an intra group transaction. An intra-group transaction is a transaction in which a company disposes of assets to another company and as a result of that transaction such companies form a group of companies.

The assets transferred may constitute either trading stock or capital assets. Such assets retain their nature in the hands of the transferee as they were in the hands of the transferor. The roll-over relief is reversed where the group relationship between the transferor and transferee ceases to exist within 6 years of the transfer of the assets (i.e. de-grouping charge). Furthermore, any gains realized from the disposal of the asset by the transferee within a period of 18 months from the period of transfer of the assets cannot be used to offset any losses.

The intra-group transaction roll-over relief provisions apply automatically unless both the transferor and the transferee elect that the provisions should not apply.

II. Reasons for change

Previously, taxpayers had to make an election into the intra-group transaction roll-over relief provisions. The presumption was reversed in 2009 to ease the enforcement or compliance burden on the taxpayers conducting intra-group transactions.

There is no procedure (i.e. form) for the election-out option for intra-group transactions. The election-out is also administratively burdensome for taxpayers who engage in the intra-group transfer of trading stock on a daily basis.

It is also difficult to trace the location of assets transferred under an intra-group transaction for 6 years or, for 18 months, where the transferee disposes of the asset within 18 months

III. Proposal

Regular and continuous trading stock must be excluded from the de-grouping charge provisions. Assets transferred by a transferor and constituting trading stock that is “regularly and continuously” disposed of by the transferee must be excluded from the de-grouping charge.

Elections should also be reversed such that the roll-over relief must not apply automatically. Taxpayers should elect that the roll-over relief provisions apply. The election should be made in writing at the time of conclusion of the agreement for the transfer of assets.

IV. Effective date

The amendment must apply to transactions occurring during the year of assessment ending on or after 31 December 2009.

4.8. DEVALUED FINANCIAL INSTRUMENTS HELD AS TRADING STOCK

[Applicable provision: Section 22(1) (a); definition of “allowance asset” in section 41 (“allowance asset”); section 11(i) and (j) of the Income Tax Act]

I. Background

Financial accounting recognises inventory as a balance sheet asset equal to the lesser of cost or net realisable (market) value. The tax rules for trading stock tax are consistent with financial accounting, effectively allowing a net deduction on devalued trading stock prior to disposal.

This “lower of” rule generally applies inclusive of financial instruments. For instance, individual share-dealers are permitted to value the closing stock at lower of cost or market value. However, a specific exclusion from the “lower of” rule exists for company held shares. Valuation of company held shares can only be taken into account at cost.

II. Reasons for change

The “lower of” cost or market value rule should not apply to any form of financial instrument, not just company-held shares. The original trading stock rule was enacted at a time when all forms of inventory (including financial instruments) fell within the same accounting paradigm. In recent years, however, financial instruments have become subject to a wholly different set of rules. These revised rules (known as “mark-to-market” accounting) often recognise both appreciations and devaluations of financial instruments at year-end (whether disposed of or retained). Meanwhile, the current trading stock rules for tax purposes account only for a reduction in market value, but not appreciation.

The Income Tax Act already recognises the distinction between regular assets and financial instruments. To this end, the Income tax Act affords companies dealing in instruments, interest rate agreements or option contracts an opportunity to use alternative methods to determine their market value. This limited form of adjustment recognises that any market value adjustments must account for both depreciation and appreciation.

III. Proposal

It is proposed that all financial instruments be excluded from the trading stock “lower of” cost or market value rule (meaning that cost will be the only allowed methodology). This exclusion applies regardless of the nature of the holder (e.g. regardless of whether the holder is a company, trust or natural person).

Two collateral considerations must be taken into account as a result of this exclusion, as provided below.

(i) Bad and doubtful trading stock debts: The “lower of” rule currently utilised for trading stock implicitly accounts for bad and doubtful debts. Taxpayers with bad and doubtful debts qualifying as trading stock are accordingly able to subtract the decline in market value. However, the removal of financial instruments from the trading stock rule eliminates this implicit reduction. In the absence of this “lower of” rule, recourse will now be required in respect of the specific bad and doubtful debt rules (sections 11(i) and (j)), previously reserved for capital assets as a practical matter. (The specific bad and doubtful debt rules were previously not applicable because the reduction was claimable under the trading stock rules; with the removal of the implicit trading stock relief, the bad and doubtful debt rules become applicable without the need for legislative change.)

(ii) Bad and doubtful trading stock in corporate re-organisations: Corporate reorganisations have always enjoyed roll-over relief in respect of allowance assets, which include debts (that become bad or doubtful before or after the reorganisation). An allowance asset is defined as a capital asset (i.e. does not currently include a trading stock). This exclusion becomes problematic for bad and doubtful debts in light of the new reliance required of trading stock on the specific bad and doubtful debt rules. Therefore, allowance assets will be specifically extended to include all bad or doubtful debts, regardless of whether those debts qualify as capital assets or trading stock.

IV. Effective date

The proposed removal of the “lower of” trading stock rule for financial instruments will be effective from years of assessment beginning on or after 1 January 2010. The proposed amendment in respect of the transfer of bad or doubtful debts in corporate reorganisations will be effective for transfers occurring on or after 1 January 2010.

4.9. REVISED TAXATION OF SHORT-TERM INSURERS

[Applicable provision: Subsections (2), (7) and (9) of section 28 of the Income Tax Act]

I. Background

Insurance premiums received by short-term insurance companies are includable in gross income. Short-term insurance businesses also incur liabilities in respect of potential claims lodged by policyholders. Specific offsetting deductions are allowed against premium income for these liabilities.

In the main, these deductible liabilities would be in respect of:

- claims incurred by policyholders, but not yet reported (“IBNR”), and
- unearned premiums as required under the Short-Term Insurance Act, 1998 (Act No. 53 of 1998).

The latter calculation takes into account the ‘best estimate value’ required by the Financial Services Board in order to maintain sustainable reserves against future commitments. SARS is empowered to make adjustments in respect of this calculation.

II. Reasons for change

The Financial Services Board is currently undertaking a review of the reserving requirements for short-term insurance companies. The proposed new rules are likely to evolve over the next few years before final resolution, this review has created some uncertainty in the market and for SARS.

A close reading of the short-term insurance provisions also reveals an overlap relating to IBNR and unearned premiums. Technically, this overlap could lead to a double deduction if left unresolved.

III. Proposal

In view of the pending changes to the short-term insurance system of liability reserves being undertaken by the Financial Services Board, it is proposed that current discretion by SARS to adjust deductible reserves be extended. This revised discretion will cover all short-term insurance deductions otherwise allowed against premiums. This expanded discretion will remain in force until a more objective set of rules can be established after completion of the pending changes underway by the Financial Services Board.

In addition, the current overlap between deductible IBNR and estimated unearned premiums will be eliminated in the context of both the onshore and offshore short-term insurance businesses. More specifically, deductions allowed as IBNR cannot be claimed again as estimated unearned premiums.

IV. Effective date

The proposed amendment will be effective for years of assessment commencing on or after the date that the amendment Act is promulgation.

4.10. ONGOING REFINEMENTS TO THE DIVIDENDS TAX

I. Background

In 2008, Government announced its intent to switch from the Secondary Tax on Companies in respect of dividends to a new system known as the Dividends Tax. Initial legislation was enacted in 2008 with substantial modifications in 2009 based on public comment.

The Dividends Tax will become effective three months after a date set by the Minister. The Minister will set this date once the tax treaty renegotiation process is complete. Renegotiation will focus on the Dividends Article for a number of tax treaties so that adjustments are made to ensure that South Africa receives a minimum 5 per cent rate on dividends flowing offshore.

II. Reasons for change

Although most of the issues relating to the Dividends Tax have been resolved, a few issues remain. Some of these issues are being resolved under the present cycle as outlined below. Further small modifications can be expected as the proposed legislation nears implementation once many taxpayers interact more closely with the legislation and implement operational systems.

4.11. DIVIDENDS TAX: WITHHOLDING BY THE TRANSFER SECRETARY

[Applicable provisions: Section 64D (definition of “regulated intermediary”), section 64D(d) & (e) & 64H of the Income Tax Act]

I. Background

Under the proposed Dividends Tax system, two sets of withholding rules apply. As a general rule, the company paying a dividend is subject to withholding. However, if a dividend is paid to a regulated intermediary, the regulated intermediary must withhold the dividends tax. Regulated intermediaries include central securities depository participants (“CSDP”), brokers (ie. authorised users or approved nominees), collective investment schemes in securities (“CIS in securities”) and linked investment services providers (“LISP”).

Parties subject to withholding can eliminate or reduce the Dividends Tax payable based on statements of exemption/reduction by the beneficial owners of the dividends. This elimination/reduction requires timely statements. If the statements are late, the excess Dividends Tax becomes refundable largely out of the Dividends Tax otherwise payable in respect of future dividends. One benefit of being an intermediary is the aggregation of dividends from various companies. As a result the refunds allowable for a regulated intermediary can be made against dividends from any company, not just dividends from the company that paid the dividend from which the tax was withheld.

II. Reasons for change

Many smaller and mid-size companies directly undertake their own transfer secretarial work (i.e. through an employee). This work includes the recording of ownership of the issuing company’s shareholdings. The holding of listed company electronic shares is largely recorded and controlled by regulated intermediaries. However, many listed companies have outstanding dematerialised (i.e. paper) shares, which may be small in percentage terms but still large in absolute amounts.

In order to ease the burden of maintaining a share register for dematerialised shares, many listed and larger unlisted outsource the transfer secretary function to an agent. The main function of the external “agent” transfer secretary’s involves the recording of share ownership and the processing of dividend payments. The outsourcing of the transfer secretarial function results in lower costs for the issuer (e.g. mailings).

Although external agent transfer secretaries perform similar functions to a regulated intermediary, these agents are not regarded as a regulatory intermediary. As a result, companies seeking to shift the dividend processing function to an external “agent” transfer secretary remain directly responsible for Dividends Tax withholding.

III. Proposal

It is proposed that a transfer secretary may be regarded as a regulated intermediary for the purposes of Dividends Tax withholding subject to SARS approval. This potential treatment is limited only to external juristic persons or partnerships transfer secretaries (not to employees). In determining whether regulatory treatment should be granted, SARS should take into account the diversity of clients (so that centralisation of the withholding function saves time in respect of SARS compliance). SARS should also take into account the sustainability of the transfer secretary in view of the fact that the transfer secretary is not subject to any regulatory capital adequacy or liquidity requirements.

IV. Effective date

The amendment becomes effective on a date to be announced by the Minister of Finance.

4.12. DIVIDENDS TAX: WITHHOLDING BY REGULATED INTERMEDIARIES

[Applicable provisions: Sections 64G(2), (3) & (4) & 64H(2) & (3) & (4) of the Income Tax Act]

I. Background

Under the Dividends Tax system, a company paying a dividend is primarily liable to withhold the 10 per cent Dividends Tax. Companies paying dividends are generally subject to this withholding obligation. However, the company’s liability to withhold the tax shifts if the dividend is paid to a regulated intermediary (e.g. a central securities depository participant). The company or intermediary may not need to withhold if the beneficial owner of the dividend is exempt. In other cases, the company or intermediary need only withhold a reduced amount if a tax treaty applies.

Exemption or reduction from withholding requires a declaration from the beneficial owner. This declaration must generally be submitted by a date specified by the company (or the intermediary). The declaration of an exempt beneficial owner (or one that is entitled to a reduced rate) must be submitted for each and every dividend paid.

II. Reasons for change

As already stated above, timely declarations of exemption are required for each and every dividend paid. Taking into account the fact that a company may have a multitude of shareholders (and intermediaries may have a multitude of clients acting as shareholders of multiple companies), repeated declarations pose a large administrative burden. In effect, many parties subject to withholding will be swamped with paper or excess data. It is also questionable whether all of these declarations will be of assistance in the audit process.

III. Proposal

The proposal is that the declaration of exemption must be valid for all future dividends paid by the intermediary until the beneficial owner advises the intermediary of the change in status. Failure to advise of change of status should trigger a penalty for the beneficial owner (see Second Amendment Bill for the penalty).

IV. Effective date

The amendment becomes effective on a date to be announced by the Minister of Finance.

4.13. DIVIDENDS TAX: REFUNDS ON INSOLVENCY OF WITHHOLDING AGENTS

[Applicable provisions: Section 64K(1) of the Income Tax Act]

I. Background

Under the Dividends Tax system, regulated intermediaries paying dividends on behalf of companies must withhold the dividends tax at the rate of 10 per cent. Regulated intermediaries ("the intermediary") include central securities depository participants ("CSDP"), brokers (i.e. authorised users or approved nominees), collective investment schemes in securities ("CIS in securities") and listed investment services providers ("LISP"). Payments of amounts withheld must be made to SARS by the last day of the month following the month in which the dividend was paid.

Exemption or reduction from withholding requires a declaration from the beneficial owner. This declaration must generally be submitted by a date specified by the regulated intermediary. The declaration of an exempt beneficial owner (or one that is entitled to a reduced rate) must be submitted for each and every dividend paid. If the beneficial owner fails to submit the declaration by the date set by the intermediary (or the date of payment of the dividend if no date is set), the intermediary must withhold the tax.

II. Reasons for change

A situation may arise where a regulated intermediary pays a dividend and that intermediary subsequently becomes insolvent. In practice, a problem arises if the insolvency arises either:

- before the dividend is paid to the beneficial owner and before the tax is paid to SARS; or

- after paying the dividend to the beneficial owner but before the tax is paid to SARS.

These situations pose problems for both SARS and the beneficial owner of the dividend. SARS potentially stands to lose the tax due while the beneficial owner remains personally liable for the tax.

III. Proposal

It is proposed that SARS waive its right to recover the tax from the beneficial owner if the Dividend Tax due is withheld (or the tax and the underlying dividend are never paid over to the beneficial owner). In these circumstances, recourse by SARS will remain solely with the regulated intermediary. This result loosely matches that of shareholders operating regulated intermediaries. The sole recourse for these shareholders in respect of improperly withheld refunds is the regulated intermediary, not SARS.

IV. Effective date

The amendment becomes effective on a date to be announced by the Minister of Finance.

4.14. DIVIDEND TAX: DEFINITION OF FOREIGN DIVIDEND

[Applicable provisions: Sections 1 of the Income Tax Act ("foreign dividend" definition) and section 4(1)(d) of the Revenue Laws Amendment Act 60 of 2008 ("foreign dividend" definition)]

I. Background

In general, the current tax rules define a foreign dividend as a distribution of profits by a foreign company. This definition relies on South African tax law and company law in order to determine whether a distribution constitutes a dividend or a capital distribution. Foreign dividends are either exempt or subject to tax at ordinary rates. Foreign capital distributions are either exempt or subject to tax at capital gain rates.

II. Reasons for change

The current Secondary Tax on Companies has been replaced with a new Dividends Tax regime, which introduced a new tax definition of a dividend. The new definition treats every distribution, other than the reduction of contributed tax capital, open market repurchase on the JSE and a company's transfer of its own shares as a dividend. The new dividend definition applies only in respect of distributions made by South African resident companies. Foreign companies are not subject to the South African tax regime; and therefore; foreign companies often cannot, as a practical matter, maintain a contributed tax capital (a key component to the new definition).

III. Proposal

For purposes of the new dividend definition, it is proposed that a foreign dividend should be defined with reference to the foreign tax law definition of a dividend of the country of residence of the company making a distribution. This approach is in line with tax treaties. In the event that the foreign country of residence does not have an income tax (or similar tax system), reference must be made to that country's company law.

IV. Effective date

The amendment will come into operation on the date on which Part VIII of Chapter II of the Income Tax Act, 1962, comes into operation.

4.15. DIVIDENDS TAX: TRANSITIONAL ISSUES

[Applicable provisions: section 64Q(1) of the Income Tax Act]

I. Background

The Secondary Tax on Companies ("STC") is levied on declaration of a dividend. On the other hand, the Dividends Tax will be levied on the date that the dividend accrues. The date of payment is deemed to be the date on which the dividend accrues to the shareholder.

Certain amounts are also treated as deemed dividends for STC purposes (such as loans, advances and releases from obligations measurable in money). With the introduction of the Dividends Tax, the Value Extraction Tax ("VET") will also be introduced to replace the deemed dividend system. The VET seeks to levy tax on any value extraction effected by resident companies. Like the STC system, the VET imposes the charge on the company. The VET will be effective on the date on which the Dividends Tax becomes effective.

II. Reasons for change

The date on which a dividend accrues to a shareholder (i.e. record date or date of registration) is often not the date on which the dividend is declared. A single dividend may be declared before effective date of the Dividends Tax and accrue to the shareholder after that effective date. This creates a possibility of the double taxation.

A possibility for double taxation also exists in respect of deemed dividends and VET. For instance, a loan may be granted and treated as a deemed dividend before the effective date. If that same loan remains outstanding after the effective date, the time value of loan will also be subject to VET (based on an annual market related interest rate).

III. Proposal

In respect of dividends (as defined), the Dividends Tax will apply in respect of dividends declared and paid on or after the effective date of the Dividends Tax. The STC will only apply in respect of dividends arising before these dates.
Similarly, the VET will generally apply in respect of value extractions effected on or after the effective date of the VET. However, the VET will not apply to financial assistance (e.g. loans) if that financial assistance was previously subject to the deemed dividends charge. This exception will not apply if an STC credit arose due to repayment of the financial assistance.

IV. Effective date

The amendment becomes effective from the date on a date to be announced by the Minister of Finance.

4.16. **REVISED RELIEF FOR RESIDENCIAL ENTITIES SEEKING TO TERMINATE**

[Applicable provisions: section 9(20) of the Transfer Duty Act; section 64B(5)(k) & paragraph 45(1), paragraph 51(2) & paragraph 51A of the Eighth Schedule of the Income Tax Act]

I. Background

Before 2001, certain individuals used companies or trusts to purchase residences so as to avoid the imposition of transfer duty. In 2002, this scheme was curbed by a transfer duty anti-avoidance rule that treats the transfer of a residential property entity as equivalent to a direct transfer of residential property. Additionally, a dualcapital gains tax charge came into effect so that both a company and its shareholders effectively became subject to tax on the same residential property appreciation. As a result, a company with residential property became subject to tax (i.e. the capital gains tax and the secondary tax on companies) on the realised appreciation. The shareholders of the company also became subject to the capital gains tax on the same notional gain when the shareholders disposed of the company holding the residential property.
In 2002, a two-year window period was granted to provide taxpayers with an opportunity to transfer certain residences out of pre-existing companies or trusts. Under this window period, the capital gains tax, secondary tax on companies and transfer duty liabilities for these pre-existing companies and trusts (along with their owners or beneficiaries) were eliminated.
It has since become apparent that many taxpayers failed to utilise the prior relief period. In 2009, relief was therefore granted to taxpayers under a restored window period. Under this restored window period, taxpayers qualified for relief similar to that previously allowed. However, a rollover relief mechanism was utilised in place of the market value step-up used in 2002 (the latter being allowed because minimal taxable appreciation was at stake with the capital gains tax having been introduced only as of 2001).

II. Reasons for change

Upon review, it has become apparent that various problems exist with the renewed relief initiated in 2009. Part of the purpose of this relief was to eliminate unnecessary companies and trusts. However, the 2009 relief fails to require termination of the entity. Some taxpayers are even seeking to use the continued entity as a means of undermining the estate duty and other tax charges associated with death.

Furthermore, the 2009 relief provisions do not take into account factual circumstances. For example, a residential property company may have been transferred to new shareholders after formation as part of a cash sale. The 2009 relief additionally failed to address certain common practical realities (such as use of the residence by relatives).

III. Proposal

A. Overview

It is proposed that the 2009 window relief period for residence entities be amended to remedy current inadequacies (as well as extended for another year in light of the proposed amendments). However, this revised relief retains the same core objective – to assist taxpayers with simple standardised structures where the residence was placed in a company or trust solely to avoid transfer duty.

B. Company structures

1. Qualifying criteria

The most common form of residence entity involves the use of a company to hold a residence on behalf of a sole shareholder (or together with a spouse). In these instances, it is proposed that the relief should apply to transfers that satisfy three sets of requirements: one pertaining to liquidation, the second pertaining to ownership and the third pertaining to assets. These requirements are outlined in detail below.

Liquidation: In order to qualify for relief, the company must dispose of the residence in anticipation of, or in the course of, the company's liquidation, winding up or deregistration. This liquidation, wind up or deregistration must occur within 18 months or a limited further period as allowed by SARS. The purpose of this requirement is to ensure that the relief facilitates Government's objective of eliminating unnecessary entities from the company register, thereby simplifying administration and enforcement.

Ownership: The terminating company disposing of the residence must solely be owned by a single shareholder (or by a single shareholder together with a spouse) throughout the window period. In addition, the residence must be disposed of to the same shareholder (and/or spouse). These requirements limit the relief to simple structures commonly employed and ensure that the disposal relief cannot be used as a tool for further estate planning (e.g. a tax-free transfer to relatives).

Assets: The asset requirement consists of three elements. Firstly, the residence must represent at least 90 per cent of the value of the company throughout the period in which the natural person to whom the residence is disposed of held shares in the company. Secondly, the residence must be used mainly for residential domestic purposes by the shareholder, spouse, and/or relatives throughout the same period. Thirdly, the relief applies only in relation to the portion of the residence that does not exceed two hectares. All of these requirements ensure that the property at issue is mainly dedicated to private use as opposed to investment use (with structures for the latter having a variety of purposes other than transfer duty avoidance).

2. Impact of relief

If the disposal qualifies for relief, no taxable gain or loss will apply to the company when disposing of the residence. However, all other assets disposed of by the company are taxable, including residence-related assets, such as a golf membership in the common area. Shareholders receiving the residence will not have any gain or loss on the company shares surrendered, even if a small portion of value associated with those shares represents taxable non-residence assets. Disposal of the residence will also be exempt from transfer duty, the secondary tax on companies (or the new dividends tax if the disposal occurs after the new dividends tax comes into effect).

If the residence is disposed of to the company's original shareholders (i.e. the shareholders holding company shares when the company acquired the residence), the base cost of the residence is the same as that held by the company. This base cost will equal the company's purchase price plus possible adjustments (improvements and some depreciation for partial business use).

If the residence is disposed of to persons other than the original shareholders of the company, the base cost in the residence is to be kept largely in line with current shareholder's cost of acquiring the shares. This cost again must be adjusted for subsequent improvements to the property (less applicable depreciation associated with the residence).

Example 1
Facts: Husband and wife form a company in 1995. The company purchases a house in the same year for R360 000. The amount was paid from a bank loan with the full amount guaranteed by the couple (who will pay of the loan plus interest in exchange for a loan account with the company). The couple stays in the house with their children. In 2010, the couple liquidates the company and transfers the house jointly into their own names. By 2010, the company owes R200 000 to the bank and R420 000 to the couple; the house is worth R920 000. Improvements costing R50 000 were made to the house during the 10-year period.

Result: The liquidation does not give rise to any capital gains tax, transfer duty or secondary tax on companies. The initial R360 000 cost of the house (plus the R50 000 of improvements) will be deemed incurred by the couple as if the couple incurred those costs directly (with the same 2001 capital gains transition rules applying).

Example 2
Facts: Husband and wife form a company in 1995. The company purchases a house in the same year for R360 000. The couple stays in the

house with their children. In 2004, the couple sells the company to an unrelated individual for R650 000. In 2010, the individual liquidates the company and transfers the house into the individual's own name. In 2010, the house is worth R920 000. Improvements costing R25 000 were made to the house before the 2004 sale, and another R25 000 of improvements were made afterwards.

Result: The liquidation does not give rise to any capital gains tax, transfer duty or secondary tax on companies. The individual's base cost in the house equals the R675 000 (the R650 000 amount paid for the house by individual plus the R25 000 improvements made after the acquisition).

Example 3
Facts: A couple is a potential beneficiary in a discretionary trust. The discretionary trust holds all the shares in three companies: Company 1, Company 2 and Company 3. In 1998, Company 1 purchased a house which is occupied by a beneficiary of the discretionary trust. Investment properties were purchased by Company 2 and 3 between 2001 and 2003. In 2010, Company 1 liquidates and transfers the house to the discretionary trust.

Result: The transfer of the house from Company 1 to the discretionary trust does not qualify for the proposed relief. The relief only applies to Company 1 if the house is transferred directly to natural person shareholders.

C. Trust structures

1. Qualifying criteria

In addition to company structures outlined above, the other form of residence entity involves the use of a trust. In these instances as with companies, it is proposed that the relief should apply to transfers that satisfy three sets of requirements: one pertaining to liquidation, the second pertaining to trust acquisition and the third one pertaining to assets. These requirements are similar to those of companies, except for the fact that the key parties control the trust through means other than share ownership.

Liquidation: In order to qualify for relief, the trust must dispose of the residence in anticipation of or in the course of the trust's liquidation.[how does a trust liquidate?] This trust must be wound up within 18 months or limited further period allowed by the SARS.

Transfer: The donor alone (or together with a spouse) must have disposed of that residence to the trust by way of a donation, settlement or other disposition or have financed all the expenditure that was actually incurred by the trust to acquire and to improve the residence. On disposal, the residence must be transferred to the same donor (and/or spouse). These requirements limit the relief to simple structures commonly employed and ensure that the disposal relief cannot be used as a tool for estate planning (e.g. a tax-free transfer to relatives).

Assets: The asset requirement consists of three elements. Firstly, the residence must represent at least 90 per cent of the value of the trust throughout the period in which the trust held the residence. Secondly, the residence must be used mainly for residential domestic purposes by the donor, spouse, and/or relatives throughout the throughout the same period. Thirdly, the relief applies only in relation to the portion of the residence that does not exceed two hectares. All of these requirements ensure that the properties at issue dedicated to private use as opposed to investment (with structures for the latter having a variety of purposes other than transfer duty avoidance).

2. Impact of relief

If the disposal qualifies for relief, the transaction will be eligible for rollover relief (much like a company). As such, no taxable gain or loss will apply to the trust when disposing of the residence. However, all other assets disposed of by the discretionary trust are taxable, including residence-related assets, such as a golf membership in the common area. Disposal of the residence will also be exempt from transfer duty.

On disposal of the residence, the base cost of the residence to the transferees is the same as that held by the company. This base cost will equal the discretionary trust's purchase price plus possible adjustments (improvements and some depreciation for partial business use). There is no rule for subsequent owners as it is not possible under common law to sell the interest in a discretionary trust.

Example

Facts: Husband and wife form a trust in 1995. The couple creates a loan account in terms of which they lend the trust R60 000. The trust takes a loan from the bank of R300 000 and purchases a house in the same year for R360 000 with the loan being guaranteed by the couple. The couple stays in the house with their children. In 2010, the couple liquidates the trust and transfers the house jointly into their own names. In 2010, the house is paid up and is worth R920 000. Improvements costing R50 000 were made to the house during the 10-year period.

Result: The liquidation does not give rise to any capital gains tax or transfer duty. The initial cost of the house (plus improvements) will be deemed incurred by the couple as if the couple incurred those costs directly (with the same 2001 capital gains transition rules applying).

IV. Effective date

Given the extensive changes to the initially proposed 2009 relief, the relief for terminating residence entities will be extended until the close of 2012. More specifically, this relief will apply to transfers from 1 October 2010 and ending on or before 31 December 2012. Current paragraph 51 will apply to transfers occurring on or before 30 September 2010.

4.17. CO-ORDINATION WITH COMPANY LAW REFORM

[Applicable Provisions: Scattered Throughout Income Tax Act]

I. Background

Company law in South Africa has recently undergone major transformation with the enactment of the Companies Act, 2008 (Act No. 71 of 2008). The Department of Trade and Industry is currently preparing regulations and legislative technical corrections in preparation of implementation in 2010. The new Companies Act modernises company law in line with evolving economic and international trends. This far reaching modernisation includes: (i) the removal of capital maintenance rules for determining dividends in favour of market value solvency and liquidity tests, (ii) modernisation of reorganisation rules, and (iii) the facilitation of business rescue procedures.

II. Reasons for change

Many provisions within the Income Tax Act directly or indirectly depend upon company law principles and definitions. The new Companies Act has fundamentally changed the company law arena. In view of these sweeping changes, consequential amendments to the Income Tax Act have become imperative. Some of these changes are technical while others seek to align the Income Tax Act with revised company law principles.

III. Proposal

A. Dividend definition

Under current company law principles, company dividends must come from profits and reserves. Current tracking mechanisms are impacted by par value, share premium, share capital and other similar mechanisms. One purpose of these rules is to ensure that company distributions do not strip company assets so as to wrongfully deprive the company's creditors. In line with modern trends, the 2008 company legislation completely jettisons these mechanical concepts in favour of a more commercial approach. Under the revised rules, distributions are generally tested to determine whether these dividends reduce assets below liabilities (the solvency test) and whether the dividends will deprive the company of urgently needed cash (the liquidity test).

The current definition within the Income Tax relies heavily on the capital maintenance concepts set to expire in short order. In anticipation of this change, a new dividend definition was enacted in 2008 (with refinements in 2009) that would come into implementation once the new Dividends Tax goes into effect (at a date to be announced by the Minister). The proposed dividend definition generally treats any amount transferred (or applied) by a company as a dividend unless that dividend comes from contributed tax capital. Contributed tax capital is solely a tax concept – determined without regard to company law. In essence, contributed tax capital represents the tax consideration contributed to the company in exchange for the issue of shares.

Even though implementation of the new Dividends Tax is delayed pending tax treaty renegotiation, no reason exists to delay implementation of the revised dividend definition. The new definition, like the Companies Act of 2008 legislation, is wholly divorced from previously existing capital maintenance concepts. It is accordingly proposed that the new dividend definition goes into effect once the Companies Act, 2008 goes into effect. This new dividend definition will apply for purposes of the normal income tax as well as the secondary tax on companies. (Note: a new definition for foreign dividends will also be added – see related explanatory memorandum.) All the elements associated with the old dividend definition will also be removed (e.g. reference to profits, reserves, par value and nominal value).

The current deemed dividend rules also contain some concepts that depend on the expiring capital maintenance provisions. Net profit and other limitations will accordingly be removed in favour of net asset limitations.

B. Equity share capital/equity shares

The Income Tax Act contains a series of rules for debt and another series of rules for shares. Shares have some tax benefits, such as exemption for shareholders and participation in the reorganisation rollover rules. Many tax benefits associated with shares apply only to “equity shares” or “equity share capital” – expiring terms that stem from current Company Law.

Under current law, the term “equity share capital” (and “equity shares”) literally mean a company’s “issued share capital and in relation to a close corporation, its members’ interest, excluding any part thereof which, neither as respects dividends nor as respects capital, carries any right to participate beyond a specified amount in a distribution . . .”In essence, preference shares with limited dividend rights fall outside the definition.

It is proposed that the concept of equity shares be retained without reference to the obsolete concepts of capital. Moreover, the interchangeable use of the terms “equity shares” and “equity share capital” will be removed. Although similar, both terms have a slightly different connotation creating unintended anomalies. Under the tax law as revised, the sole term will be “equity shares.”

C. General reference

The Income Tax Act contains numerous references to the current Companies Act, 1973. All these references will be updated to reflect the Companies Act, 2008.

IV. Effective date

The proposed amendments will be effective when the new Companies Act, 2008 is implemented.

4.18. MICRO-BUSINESS TURNOVER TAX REFINEMENTS

[Applicable provisions: paragraph 1 definition of ‘micro-business’ and ‘ professional service’, paragraph 3(b),(d) & (e), proviso to subparagraph (f)(iii), paragraph 5 definition of ‘ taxable turnover’, paragraph 6(a), (b) & (c), paragraph 7(a), (c) & (d) of the Sixth Schedule and section 12E (4)(c) of the Income Tax Act]

I. Background

The turnover tax system seeks to encourage the informal sector and other small businesses to enter the tax system so as to regularise their tax affairs. This system effectively acts as lower entry barrier to the tax system than the traditional gamut of taxes facing many micro businesses. For electing micro businesses, the turnover tax essentially replaces the normal tax on income, capital gains tax and the secondary tax on companies. This simplification was designed to reduce tax compliance costs which tend to be regressive for micro and small businesses.

In essence, small businesses under the turnover tax system are subject to a low rate of tax on a gross basis without deductions. The turnover tax potentially applies to businesses with an annual turnover of up to R1 million. Taxpayers utilising the turnover tax may not register for the value-added tax.

II. Reasons for change

The turnover tax became operational only as from 1 March 2009. Given its recent implementation, unanticipated technical difficulties have inevitably come to light requiring remedial legislation. These problems relate to entry criteria, the turnover calculation, transition from the normal tax into the turnover tax and the relationship of the turnover tax in connection with the value-added tax.

III. Proposal

Proposal #1: Refinement of the professional services exclusion

[Applicable provisions: section 12E(4)(c) and (d) (definitions of "investment income" and "personal service"); paragraphs 1 "professional service" definition", 3(a) and 3(d) of the 6th schedule)]

A. Background

Taxpayers cannot utilise the turnover tax system if engaged in "professional services" as defined. This rule is a total prohibition. Examples of these services are the fields of accounting, actuarial sciences, law, draftsmanship, entertainment, commercial arts, performing arts, journalism, secretarial services, broking and consulting. These services are allegedly rendered by more sophisticated, high income earning taxpayers, with profit margins that are significantly higher than those assumed in the design of the turnover tax.
In addition, taxpayers will not qualify for turnover tax treatment if more than 10 percent of their total receipts during that year of assessment consist of investment income. Investment income includes any proceeds derived from investment or trading in financial instruments or immovable property.

B. Reasons for change

The total prohibition against professional services is impractical. Some micro businesses perform activities with an element of incidental professional services. The definition also includes certain professions that lack problematic elements (high technical sophistication or high profit margins).

C. Proposal

The exclusion for professional services will be adjusted to match the exclusion utilised in the case of small business companies. Like the exclusion for small business companies, professional services and investment services cannot exceed a combined 20 per cent of total turnover. This change will allow for incidental services. For instance, if a construction business also does building drafting, the drafting activities should not disqualify the construction business if receipts from latter do not exceed 20 per cent of total turnover.

It is also proposed that certain services be dropped and adjusted in respect of the list of impermissible professional services (and from the impermissible list associated with the tax relief for small business corporations). For instance, various entertainment-related services will no longer be impermissible.

Proposal #2: Private refunds by and to micro businesses

[Applicable provisions: paragraph 5 and 7 of the 6th schedule]

A. Background

In terms of the turnover tax system, micro businesses are subject to tax on gross receipts without any deductions. This focus on pure receipts is much simpler than the net accrual calculation required by the normal income tax payable by most taxpayers.

B. Reasons for change

While the simplified nature of the turnover tax naturally gives rise to distortions, these distortions are largely offset by the special rate system employed. However, a situation could arise whereby a micro business purchases goods (and services) and then returns those goods (and services) for a full or partial refund. The subsequent refund accordingly constitutes an amount received that is includible in taxable turnover receipts, even though the refund merely restores the taxpayer to the taxpayer's initial position.

Similarly, another situation could arise whereby a micro business receives an amount in the course of its trade in one year for goods (and services) and is accordingly taxed on this amount. In the next year, the micro business is forced to refund part or all of the amount. In the end, the micro business is still taxed on the amount despite the subsequent refund. Again, tax is payable under the turnover system, even though the micro business has no net receipts.

C. Proposal

The receipts in both situations above should be neutralised in the above situations because the micro business has no net "economic" receipts. Both forms of receipts are effectively neutralised by an offsetting refund.

It is accordingly proposed that micro businesses be allowed an exclusion from taxable turnover (in the current tax year) when the micro business receives a refund (e.g. for faulty goods and services). It is also proposed that micro businesses be allowed a deduction from taxable turnover when the micro business refunds amounts that were included in taxable turnover during a prior year of assessment.

Proposal #3: Investment income versus business use disposals

[Applicable provisions:
paragraphs 3(b), 3(e), 6(a), 6(b) and 7(a) of the 6th Schedule]

A. Background

The turnover tax system replaces the taxation of ordinary revenue and capital gains within the normal tax system. The main purpose of the turnover tax is to simplify the taxation of core business receipts (e.g. trading stock and services) by micro businesses.

In terms of entry criteria, a micro business may not qualify for the turnover tax if more than 10 per cent of the micro business' total receipts consist of "investment income". Investment income includes ordinary or capital proceeds from the disposal of financial instruments or immovable property. A micro business is also disqualified if proceeds from the disposal of business-related immovable property and capital assets exceed R1.5 million over a three year period.

In lieu of capital gains taxation, the turnover tax system requires a person to include 50 per cent of capital receipts from the disposal of business-related immovable property and capital assets. In relation to companies, investment income forms part of taxable turnover (with investment income including proceeds from the disposal of financial instruments or immovable property). However, in relation to individuals, the same investment income is excluded from taxable turnover.

B. Reasons for change

In terms of entry criteria, the limitation of receipts from the disposal of business-related immovable property and capital assets exceeding R1.5 million overlaps with the 10 per cent investment income limitation. This overlap exists because investment income includes these forms of receipts (i.e. immovable property receipts and capital receipts from disposals). As a result, business-related immovable property and capital asset receipts are further limited to R100 000 (i.e. 10 per cent x R1 million) by virtue of the investment income limitation. Technical application of this latter rule effectively nullifies the specific R1.5 million threshold for business-related immovable property and capital assets.

The same duplication exists in relation to the taxation of business-related capital receipts in the hands of a company. For instance, if a company sells business-related assets generating capital receipts, the company has to include 50 per cent of these receipts in the turnover calculation. However the company should also include these receipts as investment income. Ultimately, the combined application of both rules technically results in a 150 per cent inclusion of business-related capital proceeds.

In the case of turnover calculation for natural persons, the overlap between investment income and business-related capital receipts produces a technical conflict. On the one hand, natural persons can exclude investment income, which technically includes business-related capital proceeds. On the other hand, business-related capital proceeds are specifically subject to a 50 per cent inclusion.

C. Proposal

The duplication within the investment income calculations and the business-related immovable property and capital asset rules needs to be removed. More specifically, receipts from assets will be subject to a R1.5 million limitation to the extent those assets are used for business purposes (other than trading stock). These receipts will be excluded from the investment income limitation to the extent of the overlap.

In terms of the turnover calculations, removal of the duplication will eliminate any potential argument for a 150 per cent inclusion for companies as outlined above. Removal of the duplication will also remove any argument that business-related asset proceeds can be excluded from the taxable turnover of natural persons.

Proposal #4: Transition from normal tax to the turnover tax

[Applicable provision: paragraphs 6(a) and (c) of the 6th schedule]

A. Background

Allowances granted to a pre-existing micro business during periods in which the micro business was previously subject to the normal tax are not carried over into the turnover tax system. However, if the micro business had any allowances for which there is a potential recoupment, this recoupment is included in the taxable turnover of the micro business if the recoupment arises after entry into the turnover tax system.

Assessed losses stemming from periods in which the micro business was previously subject to the normal tax are not carried over into the turnover tax system. However, these losses can be used to offset recoupments during periods in which the micro business is subject to the turnover tax on these amounts (as discussed above).

B. Reasons for change

The main advantage of the presumptive tax is simplicity. Hence, transitional rules from one system to another should be avoided as much as possible, especially where the transitional rules require the tracking of events over several years. The transitional rules for recoupments (and offsetting loss carryovers) overly complicate the system.

C. Proposal

The recoupment rules and assessed loss rules should be eliminated. Stated differently, recoupments and assessed losses should not carry over into the presumptive tax system. Any advantages or disadvantages are too small to justify the added complexity. Hence, the disposal of business use capital assets (other than trading stock) will attract a 50 per cent inclusion into taxable turnover without regard to the capital gain versus recoupment distinction (see Proposal #3: Investment income versus business use disposals).

Proposal # 5: Transition from VAT to the turnover tax

A. Background

Currently, the turnover tax takes precedence over the VAT. If a person or entity is registered for the turnover tax then that person or entity is not permitted to register for VAT.

B. Reasons for change

The cross-over between the turnover tax and the VAT is potentially problematic. If a partnership is registered for VAT, the partner or partners in that partnership are permitted (subject to certain requirements) to register for the turnover tax. No person should be simultaneously subject to the VAT and the turnover tax either directly or indirectly through a partnership.

C. Proposal

It is proposed to flip the requirement that a person or entity cannot register for VAT if already in the turnover tax. The VAT will now take precedence over the turnover tax. More specifically in the case of a partnership, the partner can only register for the turnover tax if that partnership is not registered for VAT.

IV. Effective date

Proposed changes to the entry criteria (paragraph 3 and the "professional services" definition of paragraph 1) will be effective for years of assessment beginning on or after 1 January 2011. All other changes will be effective for years of assessment ending on or after 1 January 2011.

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5. INCOME TAX: MISCELLANEOUS INTERNATIONAL AMENDMENTS

5.1. REFINEMENT OF THE PARICIPATION EXEMPTION

[Applicable provisions: Section 10(1)(k)(ii)(dd) of the Income Tax Act] and paragraphs 64B(2) and (5) of the Eighth Schedule]

I. Background

As a general rule, foreign dividends are taxable as ordinary revenue unless those dividends qualify for the participation exemption. The purpose of this exemption is to encourage the repatriation of dividends and to avoid economic double taxation. The capital gains regime for foreign shares operates in similar fashion (i.e. general taxation with a participation exemption).

In order to qualify for the participation exemption, the recipient of the foreign dividend must hold at least 20 per cent of the total equity share capital and voting rights in the distributing company. When determining the 20 per cent participation interest, hybrid equity instruments are excluded. A hybrid equity instrument entails certain forms of preference shares or other shares with debt-like characteristics.

The participation exemption also has a specific anti-avoidance provision aimed at the arbitrage of incurring deductible expenses to generate exempt dividends. More specifically, the exemption is lost if the foreign dividend forms part of any transaction, operation or arrangement in terms of which any receipt or accrual is exempt while any corresponding expenditure is deductible by the taxpayer (or any connected person). Stated differently, tax planning should not be allowed so that deductible expenditure is arranged for the specific purpose or effect of directly or indirectly generating exempt foreign dividend income.

II. Reasons for change

The participation exemption is designed to facilitate the repatriation of foreign dividends if the terms of the underlying foreign instrument make the repatriation largely elective. The participation exemption is also limited to dividends (as opposed to the repatriation of interest) because international tax precedent only recognises the need to provide indirect tax credits for the former. While current law excludes the yield from certain forms of debt-like shares, the exclusion is far too narrow.

Moreover, by manipulating specific characteristics of foreign instruments, taxpayers continue to generate deductible expense for the purpose or effect of shifting funds offshore so as to cycle those funds back into South Africa as an exempt foreign dividend. In a nutshell, these schemes involve various forms of collusion involving interest or other deductible expenses (such as guarantee fees or deductible derivative payments) paid offshore without corresponding taxable income within South Africa (e.g. as exempt foreign dividends). These payments are often indirectly retained or controlled by the payor with the assistance of various special purpose vehicles. Even though anti-avoidance rules exist with the aim of preventing this practice (as discussed above), these anti-avoidance rules appear to be largely ineffective.

III. Proposal

A. Narrowing the coverage of the participation exemption to pure discretionary payouts

In view of the concerns mentioned above, the use of the participation exemption will be narrowed so that eligible foreign dividends are limited solely to purely discretionary payouts (i.e. having a yield of a typical ordinary share dependent on company profits). The holder of these shares often has a genuine voting choice in respect of dividends with the participation exemption playing a meaningful part in the dividend decision. On the other hand, fixed preferred dividends or dividends operating roughly akin to debt lack this discretionary element. In recognition of these concerns, the dividends at issue must not contain involuntary repayment features or a debt-like yield. A similar set of exclusions will exist in the case of the participation exemption as applied to capital gains.

Involuntary repayment features: One of the fundamental differences between shares and debt is the involuntary repayment of principal. In the case of genuine debt, the creditor is entitled to repayment of principle; whereas, ordinary shares do not carry this right to repayment. Therefore, the participation exemption will not apply in respect of foreign dividends if the dividends are in respect of shares containing forced repayment features. These features will be deemed to exist if the holder has a right to sell the underlying foreign shares or an obligation to sell these shares otherwise exists. In both circumstances, repayment is outside the control of the issuer (i.e. the debtor).

Debt-like yield: Interest on debt is either fixed or variable dependent on the principal owed. On the other hand, dividends from ordinary shares are purely discretionary and based on the underlying profits of the company payor. Foreign dividends will accordingly be excluded if the dividends at issue are based on a specified rate of interest, the amount of expenditure incurred or capital subscribed for the foreign share or are not otherwise based on profits available.
One set of schemes involves the use of hybrid instruments whereby the foreign payor can deduct the amount as interest in the foreign country while seeking to claim the participation exemption as dividends within South Africa. In order to curb this cross-border arbitrage, the participation exemption will also be denied if the payment is viewed as interest under an applicable treaty.

Foreign collective investment schemes: The exclusion for dividends from foreign collective investment schemes will be retained. The decision to generate dividends in respect of these schemes largely falls outside the control of the holder.

B. Closure of cycle schemes

The proposed amendment also seeks a stronger set of anti-avoidance rules to close the offshore cycling of funds as described above. Under the revised rule, the participation exemption will not apply if the foreign dividends at issue are (directly or indirectly) determined with reference to, or are otherwise dependent upon, the payment of exempt interest by a South African payor.

Example
Facts: Parent owns Subsidiary 1 and Subsidiary 2, all three of which are South African tax residents. Subsidiary 1 pays interest to Foreign Special Purpose Vehicle X. Foreign Special Purpose Vehicle Y pays dividends to Subsidiary 2. Subsidiary 2 owns 25 per cent of the shares of Foreign Special Purpose Vehicle Y.

Result: Subsidiary 2 cannot claim the participation exemption in respect of the dividends from Foreign Special Purpose Vehicle 2 if the dividends are (directly or indirectly) determined with reference to or dependent on the interest paid by Subsidiary 1. This denial of the exemption exists even if the relationship between the two special purpose vehicles is attenuated by virtue of various entities or agreements.

IV. Effective date

The revised participation exemption for foreign dividends will apply to foreign dividends receive or accrued during any year of assessment commencing on or after 1 January 2011 (matches effective dates to previous section 10(1)(k)(ii)(dd) changes). The revised participation exemption for the disposal of foreign shares or foreign capital distributions will similarly apply to disposals or distributions occurring during any year of assessment commencing on or after 1 January 2011 (matches effective dates to previous paragraph 64B changes).

5.2. RESTRICTING CROSS-BORDER INTEREST EXEMPTION

[Applicable provision: Section 10(1)(h) of the Income Tax Act]

I. Background

Interest payable to non-residents is generally exempt from income tax. This exemption assists in attracting foreign debt capital in a competitive global environment (thereby promoting foreign capital inflows in order to support economic growth).

The interest exemption is subject to two exceptions for foreign residents that are viewed as too closely intertwined with the domestic economy. Firstly, foreign residents who conduct business in South Africa through a permanent establishment may not receive the exemption. Secondly, the exemption does not apply to foreign resident individuals that are physically present within South Africa during the year of assessment for more than 183 days.

II. Reasons for change

Tax reforms, fiscal discipline and the gradual liberalisation of exchange control are all aimed at increasing South Africa's attractiveness as a destination for foreign investment. A strong investment environment also demands a level of fiscal promotion that must be balanced against the need for revenue to fund domestic priorities.

The continued need for a cross-border interest exemption is undisputed in the current global environment. Portfolio debt capital is highly mobile, and many countries around the world exempt various forms of portfolio cross-border interest. This exemption is offered by developed countries as well as emerging economies. Hence, given these consideration, taxing interest arising from cross-border portfolio debt could easily undermine South Africa’s ability to attract foreign debt capital.

That said, a blanket exemption for cross-border interest is not without risks. The current exemption has often led to tax planning opportunities. The essence of these schemes involves various forms of collusion so that interest is paid offshore so as to generate a deduction without corresponding taxable income. These payments are then indirectly retained or controlled by the payor with the funds often coming back in a tax-free manner (e.g. dividends exempted via the participation exemption). Variations of these schemes have arisen over the years leading to certain targeted anti-avoidance measures. The latest variations often appear to lie at the core of the so-called funnel schemes previously described by the National Treasury (Media Statement, dated 20 March 2008). Other concerns arise in the context of closely-held cross-border situations where the exemption provides taxpayers with a strong incentive to use excessive debt capital in lieu of share capital. While the current thin-capitalisation anti-avoidance rule limits some of these excesses, this anti-avoidance rule operates as only a partial remedy.

In view of these concerns, the cross-border interest exemption needs to be narrowed without effecting portfolio debt capital. This narrowing would be well-in-line with international global tax practice. Even though many countries exempt interest from cross-border debt, these exemptions are largely limited to certain categories.

III. Proposal

The revised rule for cross-border interest will reverse the presumption. All interest received by foreign residents will now be taxed as an initial starting point. However, this taxation will be subject to a wide array of exemptions so that interest from domestic debt paid to foreign portfolio investors remains wholly untaxed. These exemptions will ensure that the status of foreign portfolio debt flows remains wholly unaffected. More specifically, the interest exemption for foreign residents will apply to interest from the following forms of domestic investments:

- Bonds issued by any sphere of government;
- Listed bonds on the JSE;
- Collective investment schemes
- Bank deposits;
- International trade finance (e.g. bills of exchange and letters of credit);
- Dealer and brokerage accounts; and
- Any interest received or accrued to a non-resident from another non-resident

It should be noted that the exemption for bank deposits does not include back-to-back loan agreements designed to circumvent the general rule of taxation. For instance, the exemption will not apply if the bank acts as an intermediary to facilitate the unlisted borrowing of funds by a domestic company from a foreign lender. It should be noted that many of these back-to-back schemes most likely violate the general anti-avoidance rule, but a specific anti-avoidance rule is being proposed to remove any dubious arguments to the contrary.

Example
Facts: South African Company seeks to borrow R100 000 from Foreign Lender. Instead of making a straight cross-border loan, Foreign Lender places a R100 000 deposit with South African Bank with the deposit being legally (or practically) tied to a second loan from South African Bank to South African Company. The cross-border bank deposit generates a 9 per cent yield while the loan from South African Bank generates a 10 per cent yield (with the 1 per cent differential largely acting as a hidden service fee).

Result: While interest from foreign holdings of South African bank deposits is generally exempt, the exemption does not apply in this circumstance because of the back-to-back arrangement. The South African Bank is merely a conduit for the real loan between South African Company and Foreign Lender. The interest differential should be ignored (e.g. as a mere hidden service fee). It should also be noted that this arrangement probably operates in violation of the GAAR.

The exemption will also not apply in relation to interest derived through a permanent establishment in SA and interest earned by a non-resident with a substantial physical presence in SA. The permanent establishment and physical presence exception will apply to all exemptions and not limited to the non-resident to non-resident interest exemption.

IV. Effective date

The proposed amendment will be effective for interest received or accrued on or after the date the amendment Act's promulgation.

5.3. TRANSFER PRICING

[Applicable provision: Section 31(1), (1A) and (2) of the Income Tax Act]

I. Background

A. Domestic transfer pricing

The current transfer pricing rules potentially apply to non-arm's length transactions if a supply of goods or services occurs between connected parties, and (i) one party is a resident and the other is a non-resident, (ii) one party is a non-resident and the other is a South African permanent establishment of a non-resident, or (iii) one party is a resident and the other is an foreign permanent establishment of a resident. A price is not arms length if that price differs from the price that the goods or services would fetch if the parties were independent.

Once the transfer pricing rules potentially apply as just described, SARS is empowered to adjust the consideration in respect of the transaction to reflect an arms length price for those goods or services. The adjustment may further be subject to secondary tax on companies (as if value were distributed from the company).

Tax treaty transfer pricing

Tax treaties address the concept of transfer pricing so that profit can be properly allocated between tax treaty partners. Under tax treaties (typically Article 9), transfer pricing adjustments arise if the terms and conditions of transactions between associated enterprises differ from the terms and conditions that would have occurred between independent enterprises. Once triggered, the tax treaty allows for profits to be adjusted to reflect the profits that would have arisen had arm's length terms and conditions been initially applied.

II. Reasons for change

The current wording of the South African transfer pricing rules is causing structural problems and uncertainties. More specifically, the literal wording overly focuses on isolated transactions as opposed to overall arrangements driven by an overarching profit objective. This narrow focus gives rise to artificial arguments by certain taxpayers seeking an excessive emphasis on literal terms (as opposed to a focus on the overall spirit and economic substance of the commercial objective of the arrangement at issue). The language also gives rise to an excessive emphasis on the comparable uncontrolled price method as opposed to other more practical transfer pricing methodologies. Lastly, legislative emphasis on "price" as opposed to "profits" does not neatly align with tax treaty wording, thereby creating barriers to the mutual agreement procedure available under tax treaties.

III. Proposal

A. Modernisation of transfer pricing methodology

In order to eliminate the above uncertainties, it is proposed that the South African transfer pricing rules be modernised in line with international practice. The current focus on goods and services will be revised. The revised trigger will instead be based on transactions, operations and schemes that have been effected or undertaken for the benefit of connected persons with a cross-border nexus.

Under these conditions, the SARS may impose transfer pricing adjustments if:

terms or conditions are made or imposed in the transactions, operations or schemes that differ from the terms and conditions that would have existed between independent persons acting at arms length, and
the difference confers a South African tax benefit for one of the parties.

SARS has the power to adjust the terms and conditions of the transaction, operation, or scheme to reflect the terms and conditions that would have existed at arm's length. These adjustments can accordingly be taken into account in the determination of taxable income of the parties to the transaction, operation or scheme.

IV. Effective date

The amendment will come into effect on 1 January 2011 and will apply in respect of any transaction, operation or scheme concluded on or after that date.

5.4 REGIONAL HOLDING COMPANY REGIME

[Applicable provisions: Sections 1, 9D, 10(1)(k)(ii), 31(3), 41 and 64B of the Income Tax Act and Paragraph 64B of the 8th Schedule]

I. Background

South Africa has a modernised tax system designed to fully protect the tax base. In the international arena, a number of rules exist to ensure that the tax system does not contain hidden incentives to shift income offshore.

In the main, South Africa taxes income of residents on a world wide basis. This worldwide tax system includes proportionate interests of tainted income of a controlled foreign company (CFC). Roughly speaking, a CFC is a foreign company that is more than 50 per cent owned by South African residents. Tainted income of a CFC generally includes passive income and diversionary income (the latter of which reflects income arising in circumstances likely to lead to transfer pricing).

Moreover, the secondary tax on companies is imposed on a South African resident company when that company declares dividends (including dividends stemming from foreign sourced income). Going forward, dividends tax will be charged at the shareholder level (as opposed to the current dividend charge at company-level). Tax treaties will be available to reduce the new dividends tax.

Thin capitalisation rules also exist to prevent the flow of interest offshore if the foreign debt of a South African company is excessive in relation to that company's equity. The excessive determination is a facts and circumstances test, but a general presumption exists in favour of specified foreign debt falling within a 3:1 debt equity ratio. This principle applies even if the foreign funds borrowed are immediately on-lent to offshore operations.

II. Reasons for change

South Africa is the economic powerhouse of Africa. South Africa's location, sizable economy, relative political stability and overall strength in financial services makes South Africa an ideal location for the establishment of regional holding companies by foreign multinationals. Furthermore, South Africa's network of tax treaties and investment protection agreements provides ready access to other countries in the region. South Africa is therefore a natural holding company gateway into the region.

However, in order to serve as an ideal holding company jurisdiction, three sets of South African tax rules were identified as significant barriers in this regard: (i) the CFC rules, (ii) the charge on outgoing dividends, and (iii) the thin capitalisation rules.

- Firstly, the application of the CFC regime means that foreign shareholders of a South Holding company will be exposed to a double administrative tax burden if their home country also has CFCs rules. It is also questionable whether application of South Africa's CFC rules makes any sense if the bulk of the holding company's funds originate from abroad.

- Secondly, effective holding company jurisdictions do not add an another layer of cost when profits pass-thru that jurisdiction. The current Secondary Tax on Companies adds a 10 per cent charge if profits are repatriated from the holding company to foreign investors even if those funds originate from abroad (e.g. from a foreign subsidiary of a holding company). This additional layer of cost does not justify the benefit of having a regional holding company location.

- Thirdly, if the South African holding company is financed with debt capital, the thin capitalisation rules serve as another critical barrier. Many foreign investors mainly fund their holding companies with back-to-back loans. In essence, the foreign investor makes loans to the holding company with the holding company on-lending those funds to another foreign location. This arrangement would most likely be viewed as excessive, leaving the holding company with non-deductible interest payments saddled with corresponding includible interest income.

III. Proposed amendment

A. Overview

In view of the above, it is proposed that qualifying holding companies become eligible for tax relief. This tax relief would generally entail the following:

- Foreign subsidiaries of a qualifying holding company will not be treated as a CFC merely because the holding company has significant equity interests in those foreign subsidiaries;

- Dividends declared by a holding company will generally be exempt from the secondary tax on companies (or the new Dividends Tax once the new Dividends Tax comes into effect); and

- The holding company will not be deemed to violate the thin capitalisation rules merely because of the existence of back-to-back cross-border loans involving the holding company.

B. Qualifying criteria

As a starting point, it is proposed that a definition of qualifying holding company be introduced. South African companies satisfying these criteria (as described below) will receive all three sets of tax relief.

- <u>Minimum participation by shareholders</u>:

  Each shareholder of the holding company must hold at least 20 percent of the equity shares in that holding company. This requirement must be satisfied throughout the tax year.

- <u>80-20 tax value</u>:

  Eighty per cent of the tax value (i.e. base cost) of the holding company must represent (equity or debt) investments in foreign subsidiaries in which the holding company holds at least 20 per cent of the equity shares. Compliance with this requirement will be measured at the end of the tax year.

- <u>80–20 receipts and accruals</u>:

  Eighty per cent of the total receipts and accruals of the holding company must be derived from foreign subsidiaries in which the holding company holds at least 20 per cent of the equity shares. These qualifying receipts and accruals include management fees, interest, royalties, dividends and sale proceeds derived from those foreign subsidiaries. This requirement will be measured at the end of the tax year.

- <u>Uninterrupted compliance</u>:

The holding company must have always complied with the abovementioned requirements in respect of each year of assessment since the company's inception. Therefore, for a company to qualify as a holding company, the 20 per cent ownership requirement must be satisfied for each day of the company's existence and to satisfy both sets of 80-20 requirements as of the close of each tax year of its existence. This uninterrupted requirement will apply to existing companies seeking to enter the holding company regime as of the effective date of this regime and to new companies established after the effective date.

In order to discourage artificial entry into the holding company regime (so as to artificially avoid the uninterrupted compliance requirement), qualifying holding companies will be deemed to be non-residents for purposes of the reorganisation rollover rules. As a result, non-qualifying companies cannot enter into a reorganisation (e.g. amalgamation) rollover with qualifying holding companies.

C. Controlled Foreign Company impact of qualifying holding company foreign subsidiaries

For purposes of determining whether a foreign company is a CFC in relation to a qualifying holding company, it is proposed that the qualifying holding company be deemed to be a non-resident. This change will mean that the CFC status of a foreign subsidiary of a qualifying holding company will be determined based on the indirect ownership of the qualifying holding company's shareholders. Only if these indirect owners are more than 50 per cent South African will the foreign subsidiary qualify as a CFC.

Example 1:

Facts: Holding Company (a resident that meets all of the qualifying holding company criteria) is 70 per cent owned by Majority Parent Company and 30 per cent owned by Minority Parent Company. Majority Parent Company is a nonresident, and Minority Parent Company is a resident. Holding Company owns all the shares of Foreign Subsidiary 1, and Foreign Subsidiary 1 owns all the shares of Foreign Subsidiary 2.

Result: For purposes of the CFC determination, Holding Company is viewed as a foreign company meaning that CFC status for both foreign subsidiaries is determined by Holding Company's shareholders. In this case, neither foreign subsidiary is a CFC because these subsidiaries are only 30 percent indirectly owned by South African residents (i.e. indirectly by Minority Parent Company).

Example 2:

Facts: The facts are the same as Example 1, except that Majority Parent is a resident.

Result: Both foreign subsidiaries qualify as CFCs because both are 100 per cent indirectly owned by South African residents. However, any tainted income of both foreign subsidiaries will be treated as deemed income of Holding Company (not of Majority Parent Company nor of Minority Parent Company).

D. Taxation of dividends distributed by qualifying holding companies

A qualifying holding company will be deemed to be a nonresident when making distributions to qualifying holding company shareholders. Non-resident treatment means that qualifying holding companies making dividends will not be subject to the Secondary Tax on Companies (nor the proposed Dividends Tax) and that these dividends potentially qualify for the participation exemption. Note: For purposes of determining whether a distribution by a holding company is a dividend or a capital distribution, proposed domestic dividend concepts apply (e.g. impact of contributed tax capital).

Example:

Facts: Holding Company is a resident with a single class of ordinary shares outstanding. Holding Company is 70 per cent owned by Majority Parent Company and 30 per cent owned by Minority Parent Company. Majority Parent Company is a nonresident, and Minority Parent Company is a resident. Holding Company receives R3 million of receipts and accruals from the following sources: R2 million of domestic interest, R7 million of dividends from a wholly owned foreign subsidiary, and R1 million of management fees provided to the wholly owned foreign subsidiary. Holding Company declares dividends of all net proceeds to its shareholders pro rata.

Result: The dividends by Holding Company are not subject to the Secondary Tax on Companies (nor the new Dividends Tax). Both Majority Parent Company and Minority Parent Company qualify for the participation exemption in respect of all the dividends declared (i.e. the participation exemption is not limited to the profits generated by the wholly owned foreign subsidiary).

E. Thin capitalisation and back-to-back loans through a qualifying holding company

A qualifying holding company is generally subject to the thin capitalisation rules in respect of foreign loans to that company. However, for purposes of the thin capitalization determination, a qualifying holding company does not take into account any foreign loans borrowed to the extent:

- the loan proceeds are on-loaned to foreign subsidiaries; and
- the equity shares of those foreign subsidiaries are at least 20 per cent held by the qualifying holding company.

However, this exclusion comes at a price. All interest deductions incurred in respect of all of these foreign loans are ring-fenced against the interest earned from the aggregate of loan proceeds on-lent to the 20 per cent or greater foreign subsidiaries. Unused losses from the excess interest incurred are deemed to be incurred in the following year (until eventually applied against income).

Example:

Facts: Holding Company is a resident with a single class of ordinary shares outstanding. Holding Company is 70 per cent owned by Majority Parent Company and 30 per cent owned by Minority Parent Company. Majority Parent Company is a nonresident, and Minority Parent Company is a resident. Holding

Company borrows funds on loan account from Majority Parent Company and fully applies the borrowed funds as a loan to a wholly owned foreign subsidiary of Holding Company. In Year 1, Holding Company incurs R140 000 of interest from the loan owed to Majority Parent Company, but Holding Company generates no interest from the amount loaned to the wholly owned foreign subsidiary. In Year 2, Holding Company incurs R140 000 of interest from the loan owed to Majority Parent Company, and Holding Company generates R200 000 of interest from the amount loaned to the wholly owned foreign subsidiary.

Result: The back-to-back loan from Majority Parent Company will not be taken into account for purposes of thin capitalization rules because the loan amount is fully applied as an on-loan to the wholly owned foreign subsidiary. However, the interest incurred is ring-fenced. None of the R140 000 interest can be deducted in Year 1. In Year 2, the cumulative interest of R280 000 can be applied against the R200 000 of interest earned from the wholly owned foreign subsidiary.

IV. Effective date

The qualifying holding company definition will come into effect on 1 January 2011 and will apply in respect of any year of assessment beginning on or after that date.

5.5. REGIONAL INVESTMENT FUND REGIME

[Applicable provisions: Insert a new section of the Income Tax Act]

I. Background

A. Conduit approach to partnerships and vesting trusts

South Africa follows a common law approach to the tax treatment of partnerships. As a general rule, the tax system does not recognise a partnership as a legal entity and thus looks through the partnership to tax the investing partners directly. If the partners are non residents, they are taxed on a source basis like any other non-resident investor.

South Africa also follows a common law approach to the tax treatment of fully vested beneficiaries in a bewind trust. If the partners are non-residents, they are again taxed on a source basis like any other non-resident investor.

B. Foreign investors and passive income

Foreign investors are subject to tax only on their South African sourced income. Interest is generally exempt. However, the exemption for interest does not apply to foreign investors if the interest is attributable to a South African permanent establishment. The rules for tax treaties roughly follow the same paradigm.

Dividends paid to foreign investors are largely subject to the STC with the tax falling upon the distributing company. Once the Dividends Tax is enacted, the investor will be subject to tax with foreign investors potentially receiving treaty relief (unless the dividends are attributable to a South African permanent establishment). Capital gains from shares (other than shares of immovable property companies) are generally exempt in the hands of a foreign investor unless the capital gain is attributable to a South African permanent establishment. The rules for tax treaties roughly follow the same paradigm.

C. Foreign investment through locally managed partnerships and trusts

International portfolio investments are often structured as limited partnerships. In a limited partnership, the general partner carries on the business of the partnership and the limited partners merely act as passive investors. In this context, if the general partner has a presence in South Africa, this presence will create a permanent establishment for each of the limited partners. As a result, each limited partner will be subject to tax in South Africa in respect of their proportionate share of passive partnership income. On the other hand, had these same investors invested directly into South Africa, most (if not all) of the same income would fall outside the South African tax net.

Similar principles also apply to trusts organised as vested bewind trust. In this instance, the activities of trustees with presence in South Africa will create a permanent establishment for the trust beneficiaries. This permanent establishment treatment again exposes the foreign investors to South African tax that would not otherwise exist if the trust beneficiaries held the underlying passive assets been held directly.

II. Reasons for change

As discussed in relation to regional headquarter companies, South Africa's location, sizable economy, relative political stability and overall strength in financial services make South Africa an ideal location for the management of regional investments. Furthermore, South Africa's network of tax treaties and investment protection agreements again provide ready access to other countries in the region.

However, the possibility of creating a taxable South African permanent establishment makes South Africa unattractive to foreign investors seeking to utilise partnerships or trusts managed within South Africa. This possibility distorts investment decisions with foreign investors often establishing parallel structures. In the typical parallel structure, foreign investors limit their South African partnership (or trust) activities to South African investment with another (more friendly tax jurisdiction) utilised to invest in the remainder of Africa. This practice creates deadweight costs to the structure and denies South African experts the possibility of managing foreign funds into the region.

III. Proposal

A. Overview

In view of the above, it is proposed that qualifying limited partners and trust beneficiaries become eligible for tax relief so that tax does not deter foreign investors from utilising South Africa as a regional investment fund location. Conceptually, the tax measures proposed will have the following effect:

- Firstly, the proposal places the foreign limited partners (or trust beneficiaries) in the same position had these investors invested in directly in the underlying assets of the partnership (or trust). In essence, these investors will not be exposed to South African tax merely because of the activities carried on by a South African general partner (or trustee).

- Secondly, the management fees of the South African general partner (or trustee) will remain taxable in South Africa.

B. Qualifying limited partners or trust beneficiaries

The proposed amendment provides relief for limited partners and trust beneficiaries whose economic position is akin to a mere passive shareholder in a company. More specifically, a qualifying partner (or trust beneficiary) must satisfy all of the following requirements in respect of the year of assessment at issue:

- Liability towards third parties may not exceed the amount contributed (the partner or trust beneficiary must have limited liability like a shareholder of a company);

- The partner (or trust beneficiary) does not participate in the effective management of the business of the partnership (or trust);

- The partner (or trust beneficiary) does not have the authority to act on behalf of the partnership (or trust); and

- The partner (or trust beneficiary) does not receive any receipts or accruals in respect of services performed for the benefit of the partnership (or trust).

C. Permanent establishment exclusion

For purposes of the Income Tax Act, the general partner of a partnership (or a trust beneficiary) will be treated as an independent agent in relation to qualifying partners and trustees. Independent agent status means that the activities of a general partner (or trustee) within South Africa will not create a permanent establishment status for the qualifying partner (or trust beneficiary). This independent agent status in relation to a qualifying partner (or trust beneficiary) means that the qualifying partner (or trust beneficiary) will not be deemed to have a South African permanent establishment solely by virtue of a South African general partner (or trustee). This independent agent status has the same liberalising impact when applying tax treaties because the South African enabling legislation treats the tax treaty rules as if fully incorporated into South African tax law.

However, this independent agent status is limited. Independent agent status applies only in respect of gross receipts and accruals derived from financial instruments or the disposal of those financial instruments. Independent agent status does not exist in respect of other forms of partnership (or trust) income.

IV. Effective date

The proposal will come into effect on 1 January 2011 and will apply in respect of receipts and accruals arising during any year of assessment beginning on or after that date

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5.6. THIN CAPITALISATION IN RESPECT OF SOUTH AFRICAN BRANCHES OF A FOREIGN COMPANY

[Applicable provision: Section 31(3) of the Income Tax Act]

I. Background

The thin capitalisation rules apply if a non-resident has granted financial assistance to a resident connected person (or a resident person in whom the non-resident is entitled to participate in 25 per cent of the dividends, profits, capital or voting rights). Application of the thin capitalisation rules includes back-to-back arrangements with independent third parties or co-investors.

The thin capitalisation rules empower SARS to effectively recharacterise debt as equity by denying the deduction if there is excessive lending in relation to the capital. The total amount of the excessive interest will also be deemed to be a dividend. The level of debt is generally discretionary, but the default rule is a debt-equity ratio of 3:1.

II. Reasons for change

The thin capitalisation rules apply only to financial assistance granted by a non-resident investor to certain residents. These rules do not apply to financial assistance to another non-resident with a South African permanent establishment. Some taxpayers have sought to exploit this loophole by having a foreign company utilise a wholly owned foreign subsidiary with most or all its operations conducted in South Africa through a branch. The foreign company would also capitalise the foreign subsidiary with excessive debt. The thin capitalisation rules would not apply because both companies are non-residents and a branch is not treated as a separate entity from the head office.

III. Proposal

A. Extension of thin capitalisation

In view of the above, financial assistance by a non-resident to another non-resident with a permanent establishment in South Africa will now be subject to the thin capitalisation rules. This change effectively seeks to place foreign-owned South African branches on par with foreign-owned South African subsidiaries.

Example
Facts: A foreign holding company forms a wholly owned foreign subsidiary and capitalises that foreign subsidiary with R10 million of equity and R490 million of loan capital. The foreign subsidiary conducts most of its operations through a South Africa branch.

Result: The foreign subsidiary will be deemed to be a South African resident for thin capitalisation purposes. The thin capitalisation rules will be applied by measuring the foreign holding company's equity versus creditor interest in the foreign subsidiary (as opposed to the South African branch level).

As stated above, application of the thin capitalisation debt-equity ratio of 3:1 is discretionary. For instance, if the foreign company has a small South African branch in relation to the foreign company's foreign operations, the thin capitalisation ratio of 3:1 can be modified to the extent the interest payments are not economically attributable to South Africa.

B. Conformance with transfer pricing methodology

The OECD views thin capitalisation as part of the international transfer pricing mandate. Interest should not be deductible between related parties to the extent that the underlying debt-related finance would not have economically existed had the financing been arranged at arm's length between independent parties. The current formulation of thin capitalisation lacks this nexus. Therefore, the thin capitalisation rules will be adjusted to incorporate the arms' length principle. This alignment with international best practice will reduce potential double taxation and facilitate mutual agreement procedures should disputes arise.

IV. Effective date

The proposed amendment will be effective for interest receive or accrued for years of assessment beginning on or after 1 January 2010.

5.7 CURRENCY TRANSLATION IN THE CONTEXT OF MULTIPLE REPORTING CURRENCIES

[Applicable provisions: [Sections 9D(2A)(k), 9D(6), 24I ("local currency" definition), 25D(2) and 25D(2A) of the Income Tax Act],
[Paragraphs 43(2) and 43(7)("local currency" definition) of the Eighth Schedule] and Paragraph 4(1) of the Tenth Schedule]

I. Background

The current tax rules relating to the taxation of foreign currency are premised on the assumption that the currency of financial reporting is the starting point for the tax calculation. This starting point simplifies South African taxation of foreign currencies. The currency of financial reporting is not defined in recognition of the fact that financial reporting may come in different forms.

II. Reasons for change

The current tax regime for foreign currency does not properly cater for situations where foreign operations report in various currencies for various purposes or report in one currency but a significant part of the underlying economic activities are conducted in another foreign currency. These problems arise because a currency of financial reporting is dictated by regulations and laws of various countries, a dual listing of a company or a difference between the country of incorporation and country of tax residence. Moreover, a financial reporting currency may be different than a functional currency, the latter being determined with reference to the primary economic environment in which the entity operates (for example, the currency in which an entity primarily generates and expends cash).

III. Proposal

In view of the concern mentioned above, it is proposed that taxpayers be afforded additional flexibility for determining the starting point for taxation involving foreign currency translation. Taxpayers will now be given the option of relying on the taxpayer's functional currency or a currency utilised for any form of financial reporting, as long as the taxpayer consistently relies on that currency for tax purposes.

As to the meaning of the term functional currency, the functional currency can be determined with reference to the currency of the economic environment in which a significant part of activities are conducted. For accounting purposes, the following primary factors are considered in determining whether a currency is a functional currency:

- The currency in which sales prices are denominated and settled;
- The currency of the country whose competitive forces and regulations determines the price;
- The currency in which costs are determined and settled;
- The currency of financing activities (debt and equity instruments); and
- The currency in which receipts from operating activities are retained.

As an interpretation matter, this tax functional currency determination is currently envisioned as being effective over annual period. "Significance" of activities can conceivably by based on the relative relationship of activities throughout all dates during the year or on the basis that the particular currency is the most significant throughout most of the year despite lesser use during shorter periods of the year.

IV. Effective date

The amendment will come into effect on 1 January 2011 and will apply in respect of any year of assessment ending on or after that date.

5.8 ABANDONED HYPERINFLATIONARY CURRENCIES

[Applicable provisions: Paragraph 20(1)(h)(ii) of the Eighth Schedule to the Income Tax Act]

I. Background

The current tax rules initially determine gains or losses attributable to a foreign permanent establishment in the reporting currency of the permanent establishment, and those same rules then translate that currency to a Rand amount. If the reporting currency is hyperinflationary, the gain is measured directly in Rand. This overall conceptual framework also applies to controlled foreign companies. (Note: In a related amendment contained in this Bill, all references to reporting currency will be replaced with functional currency.)

II. Reasons for change

The current tax rules do not properly cater for situations where a foreign country abandons its currency as legal tender due to unfavourable circumstances. Typically, this abandonment will occur after a period of hyperinflation. This period of hyperinflation is often marred by the lack of reliable exchange rate information to determine the base cost as the official rate rarely reflects the true value. The speed of the currency decline also complicates the currency translation determination because the fixing of a rate at a specified time often becomes impractical due to the increasingly unstable nature of the currency.

Once a foreign currency is abandoned after a period of sharp decline in favour of a new more stable currency, accounting rules often allow for the restatement of assets at market value. While the tax rules cover hyper-inflationary currencies, no special rules exist if a country abandons its currency after a period of sharp decline. In the absence of special rules, the current tax rules require continued use of historic base cost (which is impractical as just described).

III. Proposal

In view of the fact that historic cost records become extremely inaccurate once a country abandons its currency after a period of hyper-inflation, a special rule is proposed in respect of the base cost of assets acquired before the hyper-inflationary currency is abandoned. In this instance, the base cost of these capital assets are deemed to be restated at market value. This restatement is based on the market value of the foreign assets at the beginning of the foreign tax year following the year in which the hyper-inflationary currency was abandoned.

IV. Effective date

The amendment will come into operation on 1 January 2011 and will apply in respect of any asset held during any year of assessment on or after 1 January 2009.

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6. MISCELLANEOUS VALUE-ADDED TAX

6.1. INTRA-GROUP SUPPLIES ON LOAN ACCOUNT

[Applicable Value-Added Tax Act provision: section 22(3) and a new section 22(5)]

I. Background

In the case of debts pursuant to an unwritten agreement, vendors (debtors) registered on the invoice basis for VAT must pay-back input tax deductions claimed to the extent these vendors have not paid (within a 12 month period) for supplies previously received. This pay-back applies to the unpaid consideration (i.e. the amount outstanding). The normal pay-back provision applies immediately after 12 months but in some cases may be applicable within a 12 month period.

The pay-back provision aims to create neutrality for the fiscus in the event that the creditor (i.e. the supplier who has paid over the output tax to SARS), claims an input tax deduction for a bad debt. For unwritten agreements, the creditor can claim a bad debt deduction at any time that the creditor writes off the debt as bad. The pay-back provision is based on the commercial assumption that the creditor will write off the debt after 12 months. The pay-back provision is designed to ensure that the debtor doesn't delay payment past the 12 months.

II. Reasons for change

If a group of companies is involved, the pay-back period of 12 months is too restrictive. A group may operate loan accounts for commercial reasons and often do not clear the loan accounts within a 12 month period (in effect the loan accounts also act as a form of interest free financing for a subsidiary company of the group). In practice, group companies often do not have written agreements (as it is too cumbersome) for each taxable transaction processed via the loan accounts. Therefore, current law requires the pay-back for the group company to occur immediately after 12 months.

III. Proposal

It is proposed that the pay-back provision should not apply in the case of a group of companies. Instead the pay-back provision for a group of companies can only be triggered if there is a written agreement for the cancellation of the debt by the parties involved. In effect, the creditor can only claim a bad debt deduction for VAT purposes, if the creditor and debtor agree in writing that the debtor's outstanding debt will be cancelled. This cancellation will enable the creditor to claim a bad debt and simultaneously require the debtor to pay-back the VAT inputs in respect of the outstanding debt.

Example

Facts: Holding Company (HoldCo) transacts on behalf of the group (Sub1 and Sub2) in order to secure a bulk discount. HoldCo claims the input tax and then allocates these expenses via loan accounts to Sub1 and Sub2. In terms of the intra-group supplies on loan account, HoldCo charges output tax and Sub1 and Sub2 claims input tax. Assume the loan is unpaid after 12 months and HoldCo envisages writing off the debt because Sub1 and Sub2 are experiencing cash flow problems.

Result: If HoldCo wants to claim a bad debt deduction, HoldCo cannot claim a bad debt before Sub1 and Sub2 have paid back the VAT on the outstanding debt. In effect, HoldCo and Sub1 and Sub2 must agree in writing that the pay-back and bad debt claim will occur simultaneously.

IV. Effective date

According to general principles, the proposed amendment will apply to all supplies made on or after the date of promulgation of this Bill.

6.2. REMOVING THE DOUBLE VAT CHARGE ON CESSATION OF A VENDOR'S ENTERPRISE

[Applicable Value-Added Tax Act provision: section 22(3) proviso (ii) (dd) and new section 10(5(b) proviso]

I. Background

In the case of debts pursuant to an unwritten agreement, vendors (debtors) registered on the invoice basis for VAT may be required to pay-back (claw-back) input tax deductions claimed to the extent these vendors have not paid (within a 12 month period) for supplies received. The normal pay-back provision applies immediately after 12 months but in some cases may be applicable within a 12 month period.

The pay-back provision aims to create neutrality for the fiscus based on the commercial assumption that the supplier (creditor who has paid over the output tax to SARS) claims an input tax deduction for a bad debt. In other words, the rule is designed to protect the fiscus against the creditor claiming back the VAT paid while the debtor continues to allege that the debt is outstanding and fully payable. By clawing back the VAT on the outstanding consideration of the recipient vendor after 12 months, the fiscus is protected.

Additionally, if a vendor de-registers from the VAT system, the vendor makes a deemed supply of all assets or rights associated with the vendor's enterprise at the time of de-registration. This deemed supply aims to create neutrality based on the premise that the vendor has previously claimed an input tax deduction for the assets purchased.

II. Reasons for change

A vendor that ceases to be a vendor may be liable for VAT under two different but inter-linked provisions. This problem would manifest itself in the scenario where the vendor ceasing business has outstanding debts. In these circumstances, the vendor is liable for VAT on the cessation of business and also on the claw-back of the outstanding debt on the asset. In essence, a double charge of the VAT arises on the same asset.

III. Proposal

It is proposed that the double VAT charge on the cessation of a vendor's business be removed. More specifically, if a vendor has acquired an asset on credit and at the time of cessation of business the vendor has not paid (any amount) for the asset in the vendor's possession, the cessation of business rule is turned off to ensure only one recapture of the VAT in respect of the same asset. The claw-back provision ensures that the fiscus always receives the input tax claimed by the vendor ceasing business operations. Also, where the vendor has paid a portion of the debt in respect of the asset and ceases business operations, it is proposed that the value for the deemed supply arising from the cessation of business be reduced by the quantum of the claw-back to ensure that there is no double counting of the VAT.

Example 1
Facts: Vendor purchases an asset for R114 000 (including VAT) on credit on 1 October 2009 for use in the vendor's business. Vendor claims the input tax of R14 000. On 1 May 2010, Vendor closes down business because of financial problems. At the time of cessation of business, Vendor has not paid any amount of the R114 000 for the asset in question. Assume that the open market value of the asset is R70 000 at the time of cessation of Vendor's business.

Result: Vendor is not liable for VAT on the cessation of business. Vendor is only liable for VAT in terms of the claw-back provision for failure to pay the purchase price of the asset (i.e. 14/114 x R114 000 = R14 000).

In the example above, the cessation of business provision does not apply.

Example 2
Facts: Assume same as above except that at the time of cessation of business, the Vendor paid 50 per cent of the purchase price of the asset (i.e. R57 000). Assume that the market value of the asset at time the vendor ceases business operations is R130 000.

Result: Vendor will be liable for VAT in terms of two provisions: (i) the claw-back applies to the unpaid debt of R57 000 i.e. 14/114 x R57 000 = R7 000 and (ii) the deemed supply for cessation of business less the unpaid amount that is subject to the claw-back i.e. 14/114 x (R114 000 – R57 000) = R7 000.

IV. Effective date

According to general principles, the proposed amendment will apply to all supplies made on or after the date of promulgation of this Bill.

6.3. MOVABLE GOODS SUPPLIED TO A FOREIGN-GOING SHIP OR AIRCRAFT

Applicable Value-Added Tax Act provisions: section 1 "exported" paragraph (b); section 1 "foreign-going aircraft" and section 1 "foreign-going ship"]

I. Background

The supply of movable goods by a vendor to the owner or charterer of a foreign-going ship (or a foreign-going aircraft) can be zero rated, depending on a few requirements. Firstly, the vendor must deliver the goods to the owner or charterer. Secondly, the ship (or aircraft) must go to a destination outside South Africa. Thirdly, the movable goods must be used or consumed on the ship or aircraft.

A foreign-going ship includes any vessel that is engaged in the transportation for reward of passengers or goods wholly or mainly on international voyages. Comparable rules exist for aircraft. In both cases, the goods supplied will be consumed outside South Africa and should be zero rated in line with the consumption principle of VAT.

II. Reasons for change

The current zero rating for supplies made by a domestic vendor to a locally stationed foreign-going ship (or aircraft) only applies to commercial transport. As a result, certain foreign-going ships (or aircraft) that are temporarily stationed at local ports are not covered by the zero rating provision. For instance, naval ships fall outside this rule.

It should be noted that naval ships can claim the VAT inputs on supplies received under the export incentive scheme. However this mechanism is cumbersome.

III. Proposal

It is proposed that all movable goods supplied to a foreign naval ship/vessel qualify for zero rating. This proposal will also cover comparable aircraft.

IV. Effective date

According to general principles, the proposed amendments will come into operation on the date of promulgation of this Bill.

6.4 EXIT AND RE-ENTRY INTO THE VAT SYSTEM

[Applicable Value-Added Tax Act provision: section 10(5A) and section 18(4) proviso]

I. Background

A vendor that opts into the turnover tax system must firstly deregister from the VAT system. When the vendor deregisters for VAT, the vendor is deemed to make a supply of all assets held at the time of deregistration. The vendor is obliged to pay output VAT on this deemed supply. To ease this cash-flow implication, the vendor can exclude R100 000 of this deemed supply.

At a future stage, if that same vendor (now a non-vendor) deregisters from turnover tax and returns to the VAT system, the vendor is entitled to claim input VAT on assets that the vendor brings back into the VAT net. For instance, the non-vendor's gross turnover may force the vendor out of the turnover tax and into the VAT system. Under these circumstances, a claw-back of the R100 000 relief that was granted to the vendor (on exit from the VAT system) applies to reduce the amount of the input tax that the vendor can claim.

II. Reasons for change

The VAT Act is silent on whether the R100 000 relief provision is a constant (amount) or a maximum amount. More specifically, uncertainty exists as to whether the full R100 000 can be deducted from the consideration for the deemed supply if this deemed supply is less than R100 000 (thereby creating a negative amount).

The penalty (i.e. the claw-back provision) faced by a non-vendor re-entering the VAT system from the turnover tax system is too cumbersome. Although designed for neutrality reasons, the assets upon re-entry may not have any relation to the assets initially taken out of the VAT net. Moreover even if VAT is not recaptured at this stage, VAT will apply upon the sale of the asset. Lastly the claw-back is administratively cumbersome especially for a paltry VAT amount of R12 280.

III. Proposal

It is proposed that the law be clarified to state that the R100 000 relief granted to the vendor on exit from the VAT system by virtue of entry into the turnover tax system is a maximum amount. In addition, it is proposed that the R100 000 claw-back for re-entry into the VAT be deleted.

IV. Effective date

According to general principles, the proposed amendments will come into operation on the date of promulgation of this Bill.

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7. MISCELLANEOUS MINERAL AND PETROLEUM ROYALTY AMENDMENTS

7.1. THE DEFINITION OF “WINS OR RECOVERS”

[Applicable Royalty Act section: section 1 definition]

I. Background

The Mineral and Petroleum Royalty Resources Act applies to a person that wins or recovers a mineral resource from within the Republic and transfers that mineral resource. Mineral resources are won or recovered in various ways (e.g. from mine mouth, bulk ore or residue stockpile).

II. Reasons for change

Although the royalty regime is applicable for mineral resources that are both (i) won or recovered, and (ii) transferred, no definition exists as to what is meant by the terms “won or recovered.” This lack of a definition creates uncertainty as to when a person is liable for the royalty.

III. Proposal

It is proposed that the term “wins” or “recovers” be accorded the same meaning as in the Income Tax Act. The effect of the proposal is that bulk minerals pulled out of the ground and placed in a residue stockpile will not be won or recovered (because the mineral resources are merely moved in this circumstance). The mere sale of an ore similarly cannot be viewed as a win or recovery.

Example

Facts: Company X removes various bulk minerals and places those minerals in a residue stockpile. Six months later, Company X sells the residue stockpile to Company Y. Company Y then extracts and refines the minerals from the stockpile. Company Y eventually sells the mineral resources so extracted and refined.

Result: Company X is not subject to the royalty because Company X has never won or recovered the mineral resource. However, Company Y will be subject to the royalty when Company Y undertakes the sale.

IV. Effective date

The proposal will apply to all mineral resources transferred on or after 1 March 2010.

7.2. **REMOVAL OF THE ROYALTY TRIGGER ON EXPORTS**

[Applicable Royalty Act provision: section 1 “transfer” definition]

I. Background

The triggering event for the charge imposed by the Mineral and Petroleum Resources Royalty Act is a “transfer” as defined. A transfer of a mineral resource covers a disposal of a mineral resource, the export of a mineral resource as well as consumption, theft, destruction or loss.

The export trigger applies to all exports, even if the export is eventually re-imported by the same party for ultimate sale. The rationale behind the export trigger is to reduce the control risk of audit once the mineral resource has left South Africa.

II. Reasons for change

It has come to Government’s attention that certain companies temporarily export mineral resources before returning those mineral resources to South Africa for ultimate disposal. This temporary export may occur to cover certain refining activities that are unavailable locally. Many of these entities would prefer to refine locally but have not yet completed construction of the required local facilities. These entities are then left in the unenviable position of facing a higher royalty charge during the interim period.

Moreover, it has become questionable whether the export trigger is necessary. Basic audit can reveal sales abroad as easily as local sales. Therefore, the export trigger adds little while triggering a charge for exports contrary to commercial practice.

III. Proposal

It is proposed that the export trigger for the royalty on the export of mineral resources before ultimate disposal be completely removed. Hence, if a company exports a mineral resource, followed by a sale abroad, the royalty will arise only upon the later sale.

IV. Effective date

The proposal will apply to all mineral resources transferred on or after 1 March 2010 nor will mineral resources exported before that date be deemed transferred before that date.

7.3. CORRESPONDING NOTIONAL UPLIFTMENT OF EXPENDITURE FOR MINERAL RESOURCES FALLING BELOW SPECIFIED CONDITION

Applicable Royalty Act section: section 5(1)(b) and 5(2)(b)]

I. Background

The Mineral and Petroleum Resources Royalty Act roughly seeks to ensure a minimum level of beneficiation for refined and unrefined mineral resources by specifying the condition at which mineral resources should be transferred. These rules also ensure that an excessive charge does not arise when beneficiation occurs above a specified level.

Schedule 1 specifies the condition for refined mineral resources, and Schedule 2 specifies the condition for unrefined mineral resources. If the actual specified conditions for both refined and unrefined mineral resources fall outside the conditions stated, a notional adjustment (upwards or downwards) occurs in respect of the “gross sales” base calculations.

II. Reasons for change

If a mineral resource is transferred above the specified condition, both the gross sales amount and expenditure are notionally reduced in line with the notional specified condition. However, if a mineral resource is transferred below the specified condition, the law only clearly specifies the upliftment of the gross sales amount. The determination for the concomitant expenditure is uncertain. No reason exists to deny the upliftment for concomitant expenditure.

III. Proposal

If a mineral resource is transferred below the specified condition, a notional upliftment will apply to the expenditure in respect of the mineral resource. This upliftment theoretically corresponds with the notional expenditure that would have been incurred had the mineral resource been transferred in the specified condition. It is also important to note that the upliftment of expenditure will apply when dealing with minerals with a range of specified conditions (refer to drafter's note – minerals with ranges). In this instance, the expenditure would also have to be adjusted upward to reflect the specified condition bottom of the range. The above concepts equally apply to refined (Schedule 1) mineral resources and to unrefined (Schedule 2) mineral resources.

Example
Facts: A mineral resource is transferred at a level that is 5% below the specified condition (sales value is R 1 000 000 and the concomitant costs is R 600 000). Assume that the sales price increase by 2% for each percentage increase in mineral content (for a given quantity). Further assume that costs increase by 1% for each percentage increase in mineral content. Both the sales and costs must be adjusted to reflect sales and costs at the specified condition. NOTE: the calculations and assumptions for sales and costs have to be made separately to indicate progression.

Result:
Sales upliftment: R 1 000 000 + (2 * 0.05 * R 1 000 000)
= R 1 100 000
Cost upliftment: R 600 000 + (1 * 0.05 * R 600 000)
= R 630 000

IV. Effective Date

The proposal will apply to all mineral resources transferred on or after 1 March 2010.

7.4. ROLLOVER RELIEF FOR DOMESTIC REFINING

[Applicable Royalty Act provision: new section 8A]

I. Background

The Mineral and Petroleum Resources Royalty Act applies on an extractor-by-extractor basis in respect of mineral resources transferred. The Royalty Act seeks to ensure a minimum level of beneficiation for mineral resources by specifying a minimum condition at which mineral resources should be transferred. If the actual specified condition falls outside the conditions stated, a notional adjustment (upwards or downwards) occurs in respect of the "gross sales" calculations and "the earnings before interest and taxes" calculations. Refined mineral resources are subject to a more favourable rates formula than unrefined mineral resources. All of these rules seek to ensure that mineral extractors do not seek to undermine the royalty by lowering the generally accepted minimum levels of beneficiation (first saleable point).

II. Reasons for change

While South African mineral resource extractors typically engage in refining activities, many smaller and medium-sized extractors do not have sufficient resources to engage in the full gamut of refining activities. These entities often sell to other mineral extractors who refine the mineral resources to a higher level or to completion.

However, this shift of refining activities comes at a price in respect of the royalty charge. Failure to fully refine triggers a notional uplift. This higher charge disproportionately impacts smaller and medium-sized extractors due to their lack of refining facilities. This disproportionate impact is also questionable from a policy point of view because the full gamut of refining ultimately occurs within South Africa – the only deviation is that the refining is performed by a separate party from the party engaging in the extraction for commercial reasons.

III. Proposal

It is proposed that rollover relief be granted to extractors (registered in terms of section 2(3) of the Royalty Administration Act) on the transfer of mineral resources to another extractor so registered (that subsequently wins or recovers the transferred mineral resources). This rollover relief works on an elective basis with the transferee extractor refining the mineral resource within South Africa. The transfer of the mineral resource must be done via a written agreement between the transferor and transferee and the transferee must agree to assume the royalty liability as if the extractor initially won or recovered the mineral resource.

IV. Effective date

The proposal will apply to all mineral resources transferred on or after 1 March 2010.

7.5. MINERAL RESOURCES WITH SPECIFIED CONDITION RANGES

[Applicable Royalty Act provision: new section 6A]

I. Background

The Mineral and Petroleum Resources Royalty Act seeks to ensure a minimum level of beneficiation for refined and unrefined mineral resources by specifying the condition at which mineral resources should be transferred. Schedule 1 specifies the condition for refined mineral resources and Schedule 2 specifies the condition for unrefined mineral resources. If the actual specified conditions for both refined and unrefined mineral resources fall outside the conditions stated, a notional adjustment (upwards or downwards) occurs in respect of the "gross value base" calculations and "the earnings before interest and taxes" calculations.

II. Reasons for change

It would appear that the Act is not very clear as to how to treat mineral resources that have a range of specified conditions within Schedule 2 for unrefined mineral resources. For instance, if a mineral resource falls outside the top end of range, does the adjustment downwards require a shift to the top end of the range or to the bottom end of the range? One example is iron ore (with a 61%-to-64% range).

III Proposal

From a conceptual point of view, Schedule 2 mineral resources with specified ranges should be treated as follows:

- If the resource is developed to a level falling within the range – the impacted party can utilise the actual value upon transfer of the mineral resource;
- If the resource is developed to a level falling above the range – the impacted party makes a notional adjustment down to the top end of the range; or
- If the resource is developed to a level falling below the range – the impacted party makes a notional adjustment up to the bottom end of the range.

IV. Effective date

The proposal will apply to all mineral resources transferred on or after 1 March 2010.

7.6. MINERAL RESOURCE BY-PRODUCTS

[Applicable Royalty Act provision: new section 6(5)]

I. Background

The Mineral and Petroleum Resources Royalty Act imposes a charge on the transfer of a mineral resource at the mineral resource's first actual or notional saleable point (technically referred to as a specified condition). Various separate specified levels of beneficiation exist for refined (Schedule 1) and unrefined (Schedule 2) mineral resources, depending on the mineral resources involved.

In a few instances, unrefined mineral resources (e.g. in concentrate form) are transferred with ancillary mineral resources (hereinafter referred to as by-products). As a technical matter, all but one of these by-products must be treated separately for purposes of the Mineral and Petroleum Resources Royalty Act. The one exception is Platinum Group Metals (PGMs). In this latter instance, by-products prevalent in PGMs (technically referred to as "all other metals and minerals contained in the concentrate") are treated as part of PGMs for purposes of the unrefined (Schedule 2) mineral resources calculation

II. Reasons for change

While theoretically defensible, the separation of by-products from minerals in concentrate form creates a significant enforcement and compliance burden. Actual value breakdowns between the different minerals are hard to quantify in concentrate form and the notional upliftment in value adds significantly greater complexity.

III. Proposal

It is proposed that by-products for all unrefined mineral resources (contained in Schedule 2) should follow the paradigm set for PGMs. All minerals and metals contained in a single concentrate will be viewed as part and parcel of the dominant mineral resource transferred.

IV. Effective date

The proposal will apply to all mineral resources transferred on or after 1 March 2010.

7.7. REVISED SCHEDULAR TREATMENT FOR VANADIUM

[Applicable Royalty Act provision: Schedule 1 & 2]

I. Background

Vanadium is viewed as an unrefined mineral under Schedule 2 to the Mineral and Petroleum Resources Royalty Act. The specified unrefined condition for this mineral as a concentrate is more that 1% V_2O_5 equivalent and less than 2% calcium and silica bearing gangue minerals ($SiO_2 + CaO$). According to the Act, this level represents the first saleable point for vanadium in all instances.

II. Reasons for change

It is understood that South African mining houses produce Vanadium in dilute solid solution form in other mineral species (notably Magnetite), typically with a concentration range of 1-to-2% V_2O_5 equivalent. To extract the vanadium, a rigorous beneficiation process takes place, and this process transforms the purity of the vanadium to a higher level of typically above a 98% V_2O_5 equivalent. It is understood that this level of processing represents the far most common form of vanadium transferred by South African mining houses.

It is also understood that the market for vanadium exists for an intermediate or slag form of vanadium (at a minimum purity of 10% V_2O_5).

In view of these findings the required notional calculation is completely out of line with industry practice, thereby creating unnecessary notional pricing adjustments. The current specified condition for vanadium also underestimates typical beneficiation (thereby running counter to Government regulatory policy).

III. Proposal

It is proposed that two alternate specified conditions for vanadium be created to reflect the current reality of the general South African market for vanadium. The alternate specified conditions would be vanadium in its refined state under Schedule 1. The Schedule 2 unrefined condition will still remain available for Vanadium falling below the specified refined condition.

IV. Effective date

The proposal will apply to all mineral resources transferred on or after 1 March 2010

7.8. SPECIFYING A CONDITION FOR FERROCHROME

[Applicable Royalty Act provision: Schedule 1]

I. Background

Ferrochrome is an alloy of chromium and iron containing between 50 per cent and 70 per cent chromium. Ferrochrome is produced by electric arc welding of chromite ore. The Mineral and Petroleum Resources Royalty Act (in terms of Schedule 2), contains an unrefined condition for chrome ore in lump, chips and fines. As indicated, ferrochrome is processed by refining this unrefined chrome/chromite ore.

The production of ferrochrome in South Africa basically takes on two types: carbon ferrochrome and high charge chrome. The difference between carbon ferrochrome and high charge chrome relates to their carbon and chrome content. Carbon ferrochrome is produced from higher grade ores with chrome content over 60% and carbon content of 4-6%; charge chrome has chrome content of 50-55% and carbon content of 6-8%.

II. Reasons for change

Currently, Schedule 1 of the Royalty Act does not provide for specified conditions relating to Ferrochrome mineral resource products that are produced by South African refiners. The South African refiners account for 45% of the world's production. The lack of specified conditions for ferrochrome does not reflect the market demand and supply of ferrochrome.

III. Proposal

It is proposed that two alternative first saleable points for ferrochrome be inserted into Schedule 1 to reflect the market dimensions of ferrochrome. The refined conditions would be high carbon ferrochrome with 47% Cr content or charge chrome with 50% Cr content

IV. Effective date

The proposal will apply to all mineral resources transferred on or after 1 March 2010.

7.9 IMPOSITION OF THE ROYALTY

[Applicable Royalty Act section: section 2]

I. BACKGROUND

The Mineral and Petroleum Royalty Resources Act applies to a person that wins or recovers a mineral resource from within the Republic and transfers that mineral resource. Mineral resources are won or recovered in various ways (e.g. from mine mouth, bulk ore or residue stockpile).

Mineral resources that are exported (but are not won or recovered) are not subject to the royalty. These mineral resources are normally sent abroad for stockpile purposes.

II. REASONS FOR CHANGE

The royalty regime is applicable for mineral resources that are both (i) won or recovered from within the Republic and (ii) transferred. In the case of stockpiled mineral resources there is a concern that the entity that has subsequently won or recovered a mineral resource, may not be subject to the royalty as it could be technically argued that the mineral resource was not won or recovered from within the Republic.

III. PROPOSAL

It is proposed that the charging section be amended to make the royalty applicable in the case where mineral resources have been sent abroad for stockpile purposes and subsequently sold.

Example
Facts: Company X removes various bulk minerals and places those minerals in a residue stockpile. Six months later, Company X exports the residue stockpile to Company Y (a South African company). Company Y then extracts and refines the minerals from the stockpile. Company Y eventually sells the mineral resources so extracted and refined (outside South Africa).

Result: Company X is not subject to the royalty because Company X has never won or recovered the mineral resource. However, Company Y will be subject to the royalty when Company Y undertakes the sale as the mineral resource originated from South Africa.

IV. EFFECTIVE DATE

The proposal will apply to all mineral resources transferred on or after 1 March 2010.
