

# **Standing Committee on Finance (SCOF): Report-Back Hearings**

**[Date: 3 August 2010]**

## **Taxation Laws Amendments Bills, 2010**

### **Draft Response Document from National Treasury and SARS, as presented to SCOF (Final version of this document will be published by date of introduction of the Bills)**

#### **1. BACKGROUND**

##### **1.1 Process**

The Taxation Laws Amendment Bills, 2010 contain the annual tax proposals as announced in the 2010 Budget Review. The Bills were released on the website on 10 May 2010. National Treasury and SARS briefed the Standing Committee on Finance at a hearing on 18 May 2010. Public responses from interested parties were presented to the Committee on 1 June 2010. Public written responses to the National Treasury and SARS were due by 11 June 2010.

##### **1.2 Public comments**

Approximately 60 organisations provided comment of over 500 pages (Annexure). National Treasury/SARS workshops were also held with taxpayers and tax practitioners to further clarify the issues. Two all-day workshops were conducted on 24 and 25 June 2010. Separate meetings to discuss specialised issues were also held, including workshops relating to the Mineral and Petroleum Resources Royalty Act and a workshop relating to Islamic finance. The official report back to the Standing Committee on Finance is on 3 August 2010. This draft document will be finalised after the hearings, and published by the date of introduction of the Bills to the National Assembly, expected to be later this month.

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

Provided below are the responses to the policy issues raised by the public comments received. Both policy and technical issues have been fully reviewed as included within the revised Bills as appropriate. Comments that fall wholly outside the scope of the Bills have been disregarded but will be reviewed as part of the Annexure C process for future years.

##### **EMPLOYMENT, INDIVIDUALS AND SAVINGS**

##### **2.1 Employer-Provided Motor Vehicles (Main reference: Clause 87; paragraph 7 of the 7<sup>th</sup> Schedule)**

*Comment:* The proposed increase from 2.5 per cent to 4 per cent as the revised monthly inclusion rate for company motor vehicles is too high. The proposed rate is higher than the cost of the vehicle to the employer. The proposed rate also exceeds the monthly leasing value.

*Response:* Accepted. The proposed monthly rate of 4 per cent will be reduced to 3.5 per cent which is more or less in line with the employer's market related cost of a vehicle in respect of a full operating lease including the cost of fuel. The reduced rate will equally apply to all vehicles (i.e. the first and additional vehicles provided by the employer).

*Comment:* The monthly inclusion rate fails to account for depreciation. The inclusion rate should reduce over time.

*Response:* Not accepted. The proposed amendment is partly designed so that the treatment of employer-provided motor vehicles is broadly aligned with a car allowance. In respect of the car allowance, deductions do not reduce over time for depreciation with the tables instead presuming a residual value designed to reach a comparable result. The same principle will apply for employer-provided motor vehicles.

*Comment:* The determined value utilised for the monthly inclusion rate should exclude the cost of maintenance plans if contained within the vehicle purchase price. The current inclusion results in a doubling effect because maintenance costs are already taken into account in the proposed percentage rate.

*Response:* Accepted. Relief will be provided to remove the potential double counting of maintenance plans currently contained within the proposal. More specifically, when a maintenance plan is included in the purchase price the monthly fringe benefit rate will be reduced from 3.5 per cent down to 3.25 per cent. The maintenance plan must cover all maintenance expenses, other than consumables such as tyres.

*Comment:* The determined value utilised for the monthly inclusion rate should exclude value-added tax. Employers can often claim back the value-added tax when purchasing vehicles so an automatic inclusion in the determined motor vehicle value as proposed often results in an excessive charge.

*Response:* Not accepted. The rationale for the proposed amendment is to tax the value of the benefit granted to an employee from the employee's perspective. If an employee purchases a vehicle in his or her personal capacity, value-added tax is always payable. Employer relief from value-added tax is not appropriate.

*Comment:* Special relief should exist for employees who use vehicles as "tools of trade" (such as sales representatives and assessors mainly on the road away from home as well as vehicles used in construction and transport businesses). The proposed high level of withholding prejudices these employees by limiting their business travel relief to year-end (i.e. the cash-flow required to pay the monthly tax charge does not exist for lower-end employees).

*Response:* Accepted. It is acknowledged that certain employees may utilise employer-provided vehicles almost exclusively for employer convenience. These employees will indeed be disadvantaged in cash-flow terms if relief is available only upon assessment. Therefore, it is proposed that employers be able to reduce the 2.8 per cent (80 per cent of 3.5 per cent) monthly withholding down to 0.7 per cent (20 per cent of 3.5 per cent) if they are satisfied that the vehicle will not be used more than 20 per cent for private purposes. However, to protect the fiscus, should the employer not have proper grounds for this reduction, the employer will become jointly liable for the shortfall.

*Comment:* Temporary 24-month relief in respect of employer provided motor vehicles similar to the 24-month housing relief for employees should exist for new foreign expatriates stationed in South Africa. This relief is needed to reduce the cost of attracting foreign skills to South Africa.

*Response:* Not accepted. The situation described is economically a fringe benefit for the employee (as opposed to a “tool of trade” for the benefit of the employer). The very essence of the fringe benefit tax system is to prevent employers from creating packages designed to reduce employee’s tax as a means of attracting employees. Fairness dictates that all salary packages should be taxed according to the value obtained. Moreover, as mentioned above, the proposal is designed to mirror the provisions applicable to the car allowance, which also lacks any special rules for foreign expatriates. Lastly, the housing relief referred to was not designed as an incentive but instead to relieve employees from the substantial fixed cost of maintaining dual homes.

*Comment:* The monthly fringe benefit inclusion rate for employer-provided motor vehicles unfairly increases the monthly charge relating to UIF contributions and the Skills Development Levy.

*Response:* Partially accepted. All fringe benefit inclusions in relation to the pay-as-you-earn system have the effect of increasing the charge in respect of UIF contributions and the Skills Development Levy. No rationale exists for any deviation in this circumstance. However, it should be noted that the proposed adjustment to reduce the withholding level (to 20 per cent for motor vehicles with not more than 20 per cent private use) will indirectly reduce the UIF and Skills Development Levy burden as well. UIF also has a ceiling for contributions, thereby further mitigating the corresponding change.

*Comment:* Application of the tables unfairly penalizes cars with a value above R400 000 and creates distortions by assuming 32 000 kilometers traveled as a starting point. The intention of the monetary ceiling is also to limit the benefits to a reasonably priced vehicle. Employees making use of an employer-provided “passenger” vehicle should be able to perform their work-related duties with a vehicle below the monetary ceiling.

*Response:* Noted. As stated in the 2005 Budget Review, the ceiling referred to was introduced to address a bias in the structuring of salary packages, particularly for higher income earners. This bias encouraged the purchase of higher value vehicles and unfairly influenced household travel choices. The concern with respect to the assumed kilometers is noted but cannot be addressed at this stage. A revision of the tables requires further research. Any amending in this regard would also occur by way of regulation as opposed to amendment to the Act. The tables will be reviewed in the coming months.

*Comment:* At assessment stage, the taxable fringe benefit should be reduced by actual employee payments of private expenses even if the employee is partially reimbursed by the employer.

*Response:* Not accepted. Under the proposal, an employee may only obtain a deduction for operating expenses associated with the use of an employer-owned vehicle if the employee incurs the “full” cost. The full cost rule is designed to prevent the artificial shifting of business use costs as claims against private travel (when business-use relief occurs via the percentage reduction without regard to costs).

*Comment – Effective date:* The proposal should not apply to pre-existing vehicles used by employees. More specifically, the proposal should apply only to vehicles acquired on or after the effective date.

*Response:* Not accepted. Taxpayers are effectively asking for a fiscal stability clause for pre-existing vehicles. Tax policy has always opposed this form of effective date because this form of effective date freezes wrongful tax benefits into the indefinite future. The proposal will, however, only take effect from the beginning of the next tax year for individuals.

2.2 Narrowing of the *de minimis* interest exemption  
(Main reference: Clause 19; Section 10C)

*Comment:* The proposal unfairly undercuts friends and family seeking to assist small businesses. In effect, these parties will be receiving a lower after-tax interest yield for their loans than if they invested their funds in a bank or other financial institution. The proposal also undercuts the current use of the interest exemption as a small business incentive.

*Response:* Accepted. The proposed limitation in respect of the *de minimis* interest exemption will be withdrawn. While concerns exist that certain shareholders are utilising debt capital instead of shareholder capital as a means of benefiting from the interest exemption, the practical impact of the proposal may not be as significant as first thought. More specifically, the proposed limitation will most likely affect middle income taxpayers who do not earn other sources of interest as opposed to wealthier taxpayers receiving interest from a variety of sources.

However, it should be noted that wider concerns exist in respect of the *de minimis* exemption as an effective tool for promoting savings. Further dedicated research and consultation will be undertaken to explore other more effective incentives to encourage savings (if any do indeed exist).

2.3 Tax-free fringe benefits for employer-provided professional fees & indemnity insurance

(Bill reference: Clause 88; paragraph 13 of the 7<sup>th</sup> Schedule)

*Comment:* The proposal unfairly limits the application of the professional subscription exemption. Membership to practice within a profession as a proposed requirement is only applicable to certain professions. Given the above, the current “*condition of employment*” test should be retained.

*Response:* Accepted. The proposal dealing with the professional fees exemption is withdrawn. The existing “*condition of employment*” test will be retained. It should be noted that the proposal adding the exemption for employer-provided indemnity insurance will proceed given the general public support in this regard.

2.4 Further revision of executive share schemes

(Main reference: Clause 12; Section 8C)

*Comment:* The proposed treatment of all distributions in respect of restricted shares as ordinary revenue will disrupt normal commercial business practice. For instance, the proposal undermines black-economic empowerment (BEE) transactions because the dividends from BEE restricted ordinary shares are used to finance the purchase of those shares by the BEE parties. The proposal should be restricted to the avoidance transactions of concern (e.g. self-liquidating preference shares).

*Response:* Accepted. The proposal will be limited solely to dividends in respect of “*restricted*” non-equity share instruments (e.g. restricted preference shares). It is these instruments that give rise to the avoidance concerns. Ordinary shares (including ordinary shares held by BEE partners) will therefore be unaffected by the proposed amendment.

*Comment:* The proposed ordinary revenue treatment by employees of restricted share distributions will result in double taxation. Payment will remain non-deductible for the company payor and even subject to the Secondary Tax on Companies. If salary treatment is viewed as the correct substance of the distribution, the payment should be deductible for the company payor and apply without the Secondary Tax on Companies charge.

*Response:* Not accepted. Because the proposal will be limited solely to dividends in respect of restricted non-equity shares, the proposal should be viewed as an anti-avoidance “*no-go*” area. Therefore, no collateral relief will apply given the lack of commercial rationale for this limited subset of instruments,

*Comment:* The proposed expansion of the anti-avoidance rules to cover all equity instrument acquisitions by directors/employees is unwarranted. Employees/directors should freely be able to purchase employer-company shares on the open market. The proposal effectively taxes these acquisitions at a higher rate than other investors making the same investments. The proposal should accordingly apply only to the acquisition of restricted equity instruments, not all instruments.

*Response:* Accepted. The proposal will be limited solely to employee/director acquisitions of restricted equity instruments. Employees and directors may freely purchase unrestricted shares on the open market without being affected by the anti-avoidance rules.

*Comment:* The proposal unfairly applies even if a taxpayer acquires a restricted instrument from a fellow employee without knowing the identity of the seller. No reason exists to apply the anti-avoidance rules if the acquisition does not have a tax avoidance purpose.

*Response:* Not accepted. Given the narrowed scope of the amendment, the proposal will apply without regard to the acquisition's purpose. The commercial rationale for one employee acquiring a restricted equity instrument from another is questionable, and the parties will probably know one another.

*Comment:* The proposed expansion of the anti-avoidance rules so as to cover all equity instrument acquisitions by directors/employees seems duplicative. The proposed amendments already include another anti-avoidance amendment that prevents employees from using the swap of restricted equity instruments as a method to undercut section 8C.

*Response:* Not accepted. The swap rules as contained in the proposed amendment are relatively narrow. Other indirect forms of swaps between employees can also arise (for example cross-cash sales, sale-share purchases). The amendment deals with these indirect swaps without creating a series of unwieldy rules.

*Comment:* It is proposed that employees/directors that swap restricted equity instruments with one another remain within the ambit of section 8C. In essence, the swap will be ignored with the swapped instruments being subject to tax at ordinary revenue rates when the swapped instruments vest at a later date. While this principle is accepted, the wording of the proposal should be extended so that the swapping of restricted equity shares of different employers should similarly qualify for rollover treatment.

*Response:* Not accepted. The proposal only creates rollover treatment when dealing directly or indirectly with the same employer because the same underlying economic investment remains at stake. In other words, rollover treatment should exist only if the employees/directors have a service nexus to the same underlying economic group. The swap of wholly different employer shares essentially represents an economic

change in investment (i.e. a de-linkage from the initial shares issued in exchange for services).

2.5 Merging lump sum termination of employment payments into the retirement fund withdrawal tax table  
(Main reference: Clause 6; section 1 “severance benefit” definition)

*Comment:* The proposed merger of the R30 000 exemption for severance benefits paid by employers leaves taxpayers in a worse position. While the severance benefits will be subject to the more beneficial retirement tables (including the R300 000 exemption), the R30 000 exemption has not been added to the pre-existing R300 000 amount. The special tables also have an adverse lifetime aggregation rule. Moreover, the merging of the tables lacks any policy rationale because employer severance payments are distinct from retirement savings lump sum payouts.

*Response:* Not accepted. The current dual system of relief for retrenched workers (one for employer-provided severance pay and the other for pre-retirement retrenchment retirement fund withdrawals) creates unintended disparities. Both systems achieve the same economic objective of temporarily assisting retrenched employees who may find themselves in financial dire straits. In both situations, the tax system is providing an element of exemption and an element of averaging in respect of lump sums received into a single year. Notwithstanding the withdrawal of the R30 000 exemption, retrenched employees will largely benefit from the special tax tables. Not only will retrenched taxpayers generally have the benefit of the R300 000 exemption; they will also generally receive the benefit of lower marginal rates as provided by the special table.

*Comment:* As a result of the proposed change, deductions are no longer permitted against severance benefits. This segregation is problematic for terminating employees with large medical costs arising in the tax year in which the termination occurs.

*Response:* Not accepted. The proposal merely places severance benefits on par with other lump sum benefits. While it is true that medical deductions cannot be applied against lump sum benefits, it should also be remembered that lump sums do not form part of the denominator when determining the 7.5 per cent threshold. Medical deductions may create an assessed loss which is carried forward to future tax years.

2.6. Key employee insurance schemes  
(Main reference: Clause 20(1)(j); Section 11(w))

*Comment:* The impact of the proposal in the case of many group life plans is unclear. Some plans appear to give rise to immediate employee fringe benefits while others do not (i.e. where the employee is not a beneficiary but receives a payment directly from the employer equal to the policy payout).

*Response:* Accepted. The changed proposal clarifies that two sets of deductible premium long-term insurance payments are available to employers. Employers can deduct long-term insurance premiums in respect of employees as long as the employees have corresponding taxable inclusions in respect of those premiums. Alternatively, employers can deduct long-term insurance to protect employers from losses in respect of certain employees (i.e. key employee policies). The latter set of policies must not be explicitly or implicitly intended for the benefit of employees. Premiums for long-term insurance outside both frameworks will not be deductible by the employer.

*Comment:* Certain unapproved plans should continue to receive the benefits of the current mismatch (immediate employer deductions with deferred employee income). Employers sometimes utilise these mechanisms to assist lower-income employees to protect employee families, especially if the employees have a culture of preferring cash to other benefits such as life insurance coverage.

*Response:* Not accepted. The proposals seek to achieve parity in the case of long-term insurance plans explicitly or implicitly intended for the benefit of employees. If an employer obtains a deduction upfront for premiums, an inclusion should exist for the employee. If no employee inclusion exists for ongoing premiums, no deduction should exist for the employer. If employers are concerned about employee reaction to inclusions, employers can forfeit the deduction. However, the parties involved cannot obtain the “best of both worlds.”

*Comment:* The revised requirements for employers to deduct key employee/director insurance policy premiums are not entirely clear. For instance, the new regime presumably seeks to limit the deduction to pure “*risk policies*” without any investment element. If so, the language needs to be changed accordingly.

*Response:* Accepted. The language will be clarified to ensure that key employee/director policy tax treatment is limited solely to pure risk policies without any cash surrender value. Plans with cash surrender (i.e. investment) values are really intended for the employee, not the employer.

*Comment:* The proposed rules for deductible “key employee/director” insurance should not exclude the cession of “unmatured” policies to employees. Cessions of “*pure risk*” policies have no cash value (the employee only benefits from lower insurance premiums going forward).

*Response:* Accepted. Cessions of “unmatured” pure risk policies will not be disallowed in the case of key employee/director plans. The prohibition of policy payouts to employees upon policy maturity in the hands of the employer, however, will remain.

*Comment:* The proposed rules for deductible “key employee/director” insurance premiums should not prevent employers from using policy proceeds to purchase a shareholder’s/member’s interest despite the fact that these

shareholders/members are also employees. Businesses legitimately use insurance to buy out deceased owners.

*Response:* Noted. The use of key employee/director policies as a shareholder buyout mechanism is a separate issue that requires further analysis. The tax consequences of these plans differ slightly from those dealt with in the proposed amendment, including differences of impact in respect of the estate duty. This issue will be addressed at a later date depending upon the information received and industry requests for resolution.

*Comment:* Taxpayers should be able to elect out of the deduction for key employee/director policies. This “election out” would result in a denial of an upfront deduction for the employer but has the benefit of eliminating all income upon the insurance payout.

*Response:* Comment misplaced. The employer will effectively be allowed to elect upfront whether the premiums are deductible/payout includible or non-deductible/payout non-includible. Taxpayers can simply design the plan so as to fall outside the deduction (i.e. make the employer the beneficiary with benefits intended for the employee).

*Comment:* The anti-avoidance rules are overly punitive. The subsequent recoupment (and denial of deductions for employers) for insurance payouts made to employees should be reduced for previously non-deductible premium contributions.

*Response:* Accepted. A reduction of gross income will be granted to the extent of previous non-deductible contributions. The denial of employer deductions will similarly be reduced.

*Comment:* The anti-avoidance rules that apply if the employer pays out policy benefits to employees are overly inclusive. The rules should not apply if the employer happens to “spontaneously” apply proceeds for the benefit of employees without any upfront intent. Moreover, it is hard to prove that otherwise existing termination benefits are not linked to a policy payout.

*Response:* Not accepted. Any test based on intention is too subjective and impractical to enforce. The “spontaneous” change of intention is precisely the weakness of current law.

*Comment:* The impact of the capital gains rules is unclear when payouts occur in respect of key employee/director insurance policies.

*Response:* Noted. Current law in respect of the capital gain impact in terms of insurance payouts remains in place. Capital gains should by-and-large be exempt in these circumstances. However, anomalies between the ordinary revenue and capital gain systems may have to be reviewed in this regard. Further comment will be required on this point and will be considered going forward.

*Comment – Effective date:* The proposal should apply only to new policies. In other words, existing policies should remain unaffected.

*Response:* Not accepted. Taxpayers are essentially seeking fiscal stability protection. Taxpayers cannot be given permanent deductions going forward merely because of a pre-existing contract. However, the law will provide the parties with the option of shifting pre-existing policies from employers to employees without additional tax cost so these policies are not trapped in employer hands due to changes in the law.

2.7 Retirement: Retirement Fund payouts to non-members  
(Reference: Clause 79; paragraph 4(1) of the 2<sup>nd</sup> Schedule)

*Comment:* It is unclear as to whether the proposals are limited to housing loans/guarantees and employer compensation for theft damages; or whether the proposal applies to all section 37D payouts. All payouts should be covered.

*Response:* Partially accepted. The proposals will apply to the full array of third party payouts as listed in the provisions of section 37D(1)(a), (b) and (c) of the Pension Funds Act – (i) housing loans/guarantees, (ii) payments to employers as compensation for losses due to theft, dishonesty, fraud or misconduct by the member, (iii) outstanding subscriptions to registered medical schemes, and (iv) outstanding insurance premiums payable to registered long-term insurers. However, the proposal will not apply to divorce and maintenance payments because these payouts are already covered elsewhere.

*Comment:* It is unclear when retirement benefits are deemed to accrue. Do they accrue on: (i) on the date when the member signs the election form, or (ii) the date that the fund is to pay the benefits according to the election?

*Response:* Accepted. The accrual date will be clarified. The accrual date will be the date of the election, not the date of benefit payout.

2.8 Retirement: Post retirement commutation (conversion) of annuities into lump sums  
(References: Clauses 77 and 78; paragraphs 3 and 3A of the 2<sup>nd</sup> Schedule)

*Comment:* The proposed relief for post-retirement commutations should presumably include insurer-provided annuities.

*Response:* Accepted. The language will be clarified. Insurer-provided annuities will be explicitly covered.

*Comment – Effective date:* Given the importance of the change, the effective date of 1 March 2011 dealing with commutation of annuities should be moved back to 1 March 2010.

*Response:* Not accepted. Retro-active application gives rise to compliance and administrative complications. Directives preceding the legislation will have to be re-opened and revised.

2.9 Partial wind-up of umbrella funds

(References: Clause 6(1)(n),(o), (v) and (w); section 1 “pension fund preservation” and “provident fund preservation” definitions)

*Comment – Effective date:* The effective date allowing for partial wind-ups should be moved back to 1 March 2008 (the date when the “pension fund preservation” and provident fund preservation” definitions were introduced).

*Response:* Accepted. The effective date will be moved back as proposed. The change generally conforms to current practice.

2.10 Pre-13 September 2007 divorce awards

(Reference: Clause 133; section 69 of the Taxation Laws Amendment Act, 2009)

*Comment:* The transitional retirement fund exemption for divorced spouses should be extended. A member should not be taxed if the non-member spouse delayed in claiming his/her benefits until the benefits accrued to the member spouse.

*Response:* Not accepted. This area has already been amended many times. The exemption discussed is merely a transitional rule to simplify the co-ordination of divorce-related pension changes. The exemption should not be extended further.

2.11 Estate Duty

(Reference: Clause 4; Section 4A of the Estate Duty Act 1955)

*Comment:* The proposed ordering rules for the “portable spousal deduction” in cases of simultaneous death are welcome. However, the ordering rules are silent as to what happens when the net estate values of both dying spouses are the same.

*Response:* Comment misplaced. The problem is more theoretical than real. The monetary effect of the portable spousal deduction for the taxpayer will be the same regardless of which estate is selected. The executors of the estates are free to choose whichever estate is desired.

**3. BUSINESS**

3.1 Anti-avoidance rule to prevent financial instrument mismatches

(Reference: Clause 42; section 23K)

*Comment:* The proposed anti-avoidance measure is overly broad and should be withdrawn. The proposal violates fundamental concepts by applying exempt income from financial instruments as grounds for reducing the deductibility of wholly unrelated financial instrument expenditure.

In addition, the proposed tightening of the tracing requirements relating to section 11(a) deductions is unrealistic. Only financial institutions have the capability of proper tracing. The rules also require tracing pertaining to pre-existing agreements dating back many years before the proposed amendment; whereas, tax records need only be maintained for the past five years.

*Response: Accepted.* The proposal is withdrawn because the proposal causes more problems than it cures. At issue is the Standard Bank Tax Court decision, which is being misapplied. The decision merely allows for *de minimis* relief in circumstances where a deposit-taking institution cannot trace the use of deductible funds to exempt receipts and accruals. The decision cannot be viewed as a wholesale disregard of the section 11(a) "production of income" requirement if exempt receipts and accruals are substantial or a planned linkage exists between deductible funds and exempt receipts and accruals.

That said, serious concerns exist that various schemes exist which effectively rely on the use of tax deductible financial instrument flows to fund exempt financial instrument receipts and accruals. While this linkage is real, taxpayers have developed a variety of means to disguise this linkage through legal and factual contrivances. Policy review of this area can be expected in due course.

### 3.2 Improvements to government land (Main reference: Clause 29; section 12N)

*Comment:* The revised allowance for improvements on government leased land does not allow for a final write-off when the lease terminates.

*Response: Accepted.* A lessee undertaking an improvement will be allowed to have a write off of the outstanding depreciable amount when the lease terminates. This write-off is consistent with the current treatment of improvements on leased land. However, the write off will not be allowed as long as the taxpayer continues to utilise the property pursuant to a renewed, extended or successive lease.

*Comment:* The revised allowance for improvements on government leased land should be extended to leasehold improvements on land owned by universities or other educational institutions (the latter of which are also exempt).

*Response: Comment misplaced.* These institutions are already within the scope of the amendment (i.e. as a section 10(1)(cA) institution). No further legislative changes are required.

*Comment:* The denial of the allowance for improvements on government leased land if the leased land is subleased is too restrictive. Subleasing should be permitted with group members. A single group may have multiple different uses for a single property with each group member operating semi-autonomously.

*Response:* Accepted. Subleasing to group members will be permitted. However, the sub-lessee must physically occupy the property for use.

*Comment:* The revised allowance for improvements on government leased land is not always beneficial for taxpayers. Some improvements are depreciable on a straight-line basis over 20 years when performed on government land under current law (such as oil tankers); whilst, no depreciation is allowable for improvements involving the same assets on directly-owned land. The revised allowance effectively means that the allowance for this latter category of improvements will be lost.

*Response:* Not accepted. The purpose of the proposal is to place lessees undertaking improvements on leased government land on par with owners making improvements to directly owned structures. Therefore, if depreciation is not allowed in respect of improvements on owned property, depreciation will not be allowed in respect of these leased improvements. Taxpayers cannot expect the best of both worlds (i.e. leasing treatment on the one hand and ownership treatment on the other).

### 3.3 Islamic Finance

*(Main reference: Clause 45; section 24JA)*

*Comment:* Only three forms of Islamic finance arrangements are covered by the proposed amendments. Other common forms of Islamic finance have inadvertently been omitted (such as the Ijara and Wakala).

*Response:* Noted. As stated in the Budget Review (2010), the Islamic finance project will run over a two-year period. The proposed amendments are merely designed to start the process. Other Islamic finance arrangements will be considered in the 2011 legislative cycle. Non-tax aspects must also be considered.

*Comment:* The legislation covers only Banks and Collective Investment Schemes. Other financial institutions (e.g. insurance companies) should also be eligible to offer Islamic products.

*Response:* Noted. The proposed legislation is based on current practices existing among financial institutions. To date, long-term insurance institutions have not entered the Islamic product market. The expansion of the regime to other financial institutions will be considered in the 2011 legislative cycle.

*Comment:* The regime should be created without reference to religion (like the United Kingdom legislation). Religion-based legislation is discriminatory and unfair, thereby favouring a particular group in society. Tax legislation should also be neutral as a principle matter – based solely on the facts of the transaction.

*Response:* Not accepted. The creation of a regime without reference to religion is too risky from an avoidance perspective. From a non-

discriminatory vantage point, the intention is merely to place Islamic finance arrangements on par with conventional financial arrangements. In addition, Islamic finance institutions offer these products to the general public; client participants are not required to be of the Islamic faith.

*Comment:* The legislation should define the concept of Shari'a compliance. Shari'a law comes in several varieties.

*Response:* Not accepted. SARS cannot be expected to validate arrangements of the Islamic faith. The current proposal requiring the products at issue to fall within the precepts of Shari'a law will accordingly be dropped. Taxpayers must simply advertise the products as compliant with Shari'a law to the general public. The reputational risk associated with false advertising should make this a self-enforcing provision.

*Comment:* Collective investment schemes do not pay any impermissible (i.e. interest) income derived from underlying investments to their unit holders. Instead, the impermissible income is donated to charities. Tax relief should be granted for the donations of impermissible income.

*Response:* Noted. The exact calculation of collective investment scheme income is part of a larger issue. This issue will have to be deferred to a later legislative cycle.

*Comment – Mudarabah:* The provisions should allow for a change in the proportionate division of the profits by mutual agreement between the parties. Shari'a law does not contain a prohibition on changing the division of profits.

*Response:* Accepted. Current reference to profits will allow for changes by mutual agreement. However, the definition will be tightened in other respects so as to more closely align with current practice. Firstly, the profits of a Mudarabah must stem from Islamic financing (i.e. depositors of the bank expect the funds to be ultimately based on underlying Islamic investments by the bank). Secondly, the relief should apply only if the yield from the funds deposited by clients is based on the amount and duration of the funds deposited (similar to the basis of an interest yield).

*Comment – Mudarabah:* The proposed inclusion of collective investment arrangements within the Mudarabah product definition is not in conformance with current practice. Within the local context, collective investment schemes fund banks via Murabaha products. Collective investment schemes do not utilise Mudarabah.

*Response:* Accepted. Collective investment schemes will be removed from the Mudarabah definition and added to the Murabaha definition as requested.

*Comment – Murabaha:* The current prohibition against variations of Murabaha installments is more restrictive than Shari'a law. Installments do vary and the total aggregate charge may be reduced for early repayments.

*Response: Accepted.* Under the proposal as revised, the total amount payable under this arrangement will simply not be allowed to exceed the initial pre-agreed total. Installments will be allowed to vary, and a reduction of the total will be permitted for early repayment. This revised proposal focusing on the total maximum limit is more consistent with Shari'a law.

*Comment – Murabaha:* The repossession requirement is not based on Shari'a principles and should therefore be deleted.

*Response: Accepted.* The requirement was intended to mandate the existence of a creditor/debtor relationship. This requirement will be deleted. Instead, as with the Mudarabah, the relief will instead apply only if the yield in respect of the arrangement is based on the amount and duration of the funds provided (similar to the basis of an interest yield).

*Comment – Murabaha:* The 180-day window period is not required by Shari'a law and should accordingly be dropped. The 180-day period also has an adverse impact on transactions if the period extends beyond the financial year of one or both parties.

*Response: Not accepted.* The rule is designed to conform with current practice wherein the bank quickly turns over the property to the client. Moreover, the 180-day period does not cut-off merely because the financial year of one or both parties ends. However, it should be noted that the 180-day period will be determined with the reference to the date of disposal (i.e. the date the agreement), not with respect to the date of registration (the latter being partially outside the parties' control).

*Comment – Murabaha:* Securities Transfer Tax relief should be granted in the case of Islamic products. For instance, Collective Investment Schemes often purchase and resell shares to the bank as part of Murabaha schemes.

*Response: Accepted.* A single level of Securities Tax Transfer relief will be provided in the case of Murabaha arrangements involving collective investment schemes. This relief will operate similarly to Transfer Duty in Murabaha arrangements.

*Comment – Diminishing Musharaka:* Shari'a standards in respect of Diminishing Musharaka do not allow for guarantees (i.e. the buying of the bank's proportional interest at the bank's original purchase price). The price on the purchase of each unit is agreed at the time of each purchase. Some Diminishing Musharaka products also do not include a rental component with the yield based solely on the purchases of proportional interests from the bank.

*Response: Accepted.* The requirements at issue will be removed. A more flexible approach will be adopted.

*Comment – Diminishing Musharaka:* The provisions do not cater for situations where the client already owns the property with bank acquiring the client's interest as a form of refinancing. The provisions also do not cater for situations

where the client already owns the underlying land and seeks financing from the bank for construction thereon.

*Response:* Accepted. The proposal will be adjusted to allow for Diminishing Musharaka used for refinancing and for construction-related loans. For instance, the rules will no longer limit these arrangements to situations where the parties jointly acquire the underlying property.

3.4 Default elections involving intra-group roll-overs  
(Main reference: Clause 60; section 45(4))

*Comment:* The rollover election for group transactions should be reversed (i.e. parties should elect “in” not “out”). While the proposed solution solves the de-grouping charge associated with the inadvertent rollover of regularly disposed inventory, the proposed solution does not solve the carry-over base cost tracing problem.

*Response:* Partially accepted. The election requirement created the impression that a specific election process is required. Historically, when the Income Tax Act required taxpayers to elect into the rollover provisions, taxpayers contended that the “election in” requirement created logistical problems. In response, the election was reversed to become an “election out.” A further reversal of this amendment is accordingly unacceptable because a further reversal would merely resuscitate the problems raised earlier.

That said, while the “election-out” mechanism reduces previous concerns, the “election out” mechanism does not solve the problem completely. Therefore the election-out mechanism will be replaced with a slightly different process. Henceforth, the transferor and transferee must merely conclude a written agreement that the roll-over relief provisions do not apply. This “agreement out” concept will apply to all company reorganisations, not simply to intra-group transfers.

*Comment – Effective date:* The 31 December 2009 year-end effective date (as stated in explanatory memorandum) is preferred over the 1 January 2010 year of assessment start date (as contained in the Bill).

*Response:* Not accepted. Admittedly, an inadvertent mismatch exists between the explanatory memorandum and the Bill. However, the amendment cannot be made retroactive because taxpayers cannot be expected to utilise a procedure (i.e. an “agreement out”) for a transaction that precedes the existence of the amendment.

3.5 Devalued financial instruments held as trading stock  
(Reference: Clause 38; section 22)

*Comment:* The proposed amendment undermines longstanding practices and creates anomalies. For instance, a trader holding fixed property will still be able to write down unrealised losses on fixed property; whereas, a trader holding

shares in a company holding fixed property trading stock cannot make the same write down for the same loss in value.

*Response:* Not accepted. The comment effectively seeks to preserve a double unrealised ordinary loss. Currently, one set of taxpayers have a write-off of the fixed property before disposal with a second set of taxpayers writing off the shares whose reduced value stems from the same underlying fixed property.

*Comment:* The stated alternative for bad debt write-offs in the explanatory memorandum is misplaced. Bad debt write-offs for money lenders occur by virtue of section 11(a) (not by virtue of section 11(i) or (j)).

*Response:* Accepted. Bad debt write offs for money lenders do indeed stem from the application of section 11(a) as suggested. The explanatory memorandum will be amended accordingly.

### 3.6 Dividends Tax

*Comment (Clause 72; section 64O):* The “repurchase rate” required for loans triggering the proposed value extraction tax should be defined.

*Response:* Partially accepted. The repurchase rate will be dropped. Instead, the new rules will be aligned to the transfer pricing rules because the rule will often be applied in a cross-border context.

*Comment:* Offsets are required for foreign companies that become a resident by shifting their management onshore. These offsets should ensure that the dividends tax does not apply to profits arising before the period of domestic residence. Current law achieves this end by exempting from the Secondary Tax on Companies all dividends on liquidation derived from pre-entry profits.

*Response:* Accepted. Foreign companies becoming South African residents (i.e. entering South African tax jurisdiction for the first time) should be allowed to enter on a clean slate. Therefore, entering companies will have an initial “contributed tax capital” equal to gross assets less liabilities (net assets).

*Comment (Clause 65(1)(f); section 64C(4)(a)):* Under current law, deemed dividends are limited to the extent of available profits. With the profit concept removed as a requirement for measuring dividends, taxpayers should be allowed to reduce deemed dividends by available contributed tax capital (a new criteria for measuring dividends).

*Response:* Not accepted. As discussed in the Parliamentary process associated with the Taxation Laws Amendment Acts, 2009, the taxpayer should not be allowed to allocate “contributed tax capital” to selected shareholders (unlike “contributed tax capital” associated with actual dividends which must be proportionately allocated to all holders of a class of shares). It should also be noted that the deemed dividend system is an anti-avoidance measure.

*Comment (Clause 71; section 64K):* The proposal protects shareholders against liability when an intermediary becomes insolvent after paying dividends to the shareholder but before paying over the withheld tax. However, no protection exists if the intermediary becomes insolvent before paying the dividend (i.e. before withholding the tax due).

*Response:* Noted. The current proposal regarding the Dividends Tax liability is being withdrawn. These concepts will be revisited in the 2011 legislative cycle in order to allow for a more comprehensive response.

### 3.7 Co-ordination with company law reform

*Comment (Clause 6(1)(d); section 1 “equity share” definition):* Under current law, an equity share can participate in either a distribution of profits or a distribution of capital. The new test seemingly requires participation in both. No reason exists for this narrowing of the definition.

*Response:* Not accepted. It has been found that taxpayers have manipulated the ‘either or’ test. The aim is to exclude preference shares because of their “debt-like” nature.

*Comment (Clause 6(1)(d); section 1 “equity share” definition) – Effective date:* More time will be required to implement this amendment so parties have time to restructure their legal share relationships. A number of structures may be indirectly impacted without the parties being fully aware (e.g. a group relationship may be broken or a 20 per cent threshold may be lost).

*Response:* Partially accepted. The general effective date remains as in the initial Bill. However any group that becomes separated as a result of this amendment will not be subject to the de-grouping charge. This de-grouping relief should alleviate any need for urgent restructuring.

*Comment:* The proposed amendment fails to provide relief for the involuntary conversion of par value shares into non-par value shares (as required by the current version of the new Companies Act).

*Response:* Noted. It is possible that the required conversion of par value shares into non-par value shares may trigger a tax disposal. Resolution of this issue will depend on final resolution of the implementation issues associated with the pending reform of the Companies Act.

*Comment:* The amalgamation rules have not been amended in line with section 40 of the new Companies Act.

*Response:* Not accepted. The Income Tax Act currently caters for amalgamations of different types (i.e. “amalgamations, conversions and mergers”). The purpose of the amalgamation rules as contained in the Income Tax Act versus the Companies Act differ as these Acts seek to achieve diverse aims. For instance, amalgamations referred to in the Companies Act seem to include de-mergers while amalgamations within

the Income Tax Act are limited to company combinations (with de-mergers addressed under the unbundling provisions).

3.8 Revised relief for residential entities seeking to terminate  
(Main reference: Clause 98; paragraph 51A of the 8<sup>th</sup> Schedule)

*Comment:* The company and trust deregistration requirements should be removed. These requirements are especially problematic in the case of trusts because trusts are used for other estate planning purposes. Trust terminations may also be impractical due to circumstances outside the control of the parties (e.g. because of the deaths of the founders).

*Response:* Not accepted. The proposed relief is based on a “quid pro quo.” Taxpayers will obtain relief in exchange for the removal of the tax avoidance structure. The proposed request effectively eliminates any corresponding benefit for Government.

*Comment:* The rules regarding trust termination must be clarified if the termination requirement is to be retained. Trust termination can occur via court order or by agreement. The references to the Trust Property Control Act also appear to be too narrow.

*Response:* Accepted. Any court order of a competent jurisdiction or any termination by valid agreement will be accepted. The narrow references will be removed.

*Comment:* The proposed relief fails to cater for the variety of family planning arrangements. Firstly, the proposed relief should cater for the situation where a trust owns a residential property company. Secondly, the proposed relief should not be limited to spousal indirect control over residential property (especially where one of the parties is deceased). Family direct or indirect control should be acceptable (e.g. shared ownership between parent and child as well as grandparent and child).

*Response:* Accepted. The proposal will be amended to cover all liquidating transfers of residential properties mainly used by and ultimately transferred to family members. Direct and indirect control arrangements will be permitted.

*Comment:* The 90 per cent asset requirement (applying throughout the period) should be reconsidered as overly restrictive.

*Response:* Accepted. Terminations will be permitted without regard to the 90 per cent requirement because only the transfer of the “residence” itself is eligible for the incentive. The only 90 per cent rule to be retained is the rule relating to company share acquisitions occurring after the residential property company is formed. The 90 per cent rule is needed in this case because taxpayers can rely on the existing base cost of the shares for application of future base cost of the residence (meaning that the economic value of the shares and the residence should effectively be the same).

*Comment:* Deemed dividend relief from the Secondary Tax on Companies and Donations tax relief should be extended to cover the sale of property at a discount to non-shareholders (i.e. to relatives of the shareholders).

*Response:* Not accepted. The amendment is not intended as a mechanism to be used as a further opportunity for tax planning. The main concern appears to be the circumstance where a residence is disposed of for the combined cancellation of loan and share capital. However, the disposal of a residence in exchange for share capital and debt capital cancellation qualifies as a value-for-value transaction that should not give rise to a taxable deemed dividend or a taxable donation. No change of law is required in this regard.

*Comment – Effective date:* The effective date deadline of the current residential property relief mechanism should focus on the date of disposal (i.e. the date that the termination agreement is concluded) versus the current focus on the transfer date (i.e. the property registration date). The latter focus is outside the control of the parties with parties possibly missing the deadline merely due to administrative delays.

*Response:* Accepted. The effective date will be shifted to date of disposal. This date is fully within the control of the parties involved.

### 3.9 Corporate reorganisations involving plantations

*Comment (Pick n Pay Employee Share Purchase Trust court decision):* The proposed amendments resolving the technical difficulties for plantation farmers seeking rollover relief are welcome. However, the proposed changes are part of a larger problem. The current division of reorganisation systems between “trading stock” versus “capital” assets fails to properly reflect the case law distinctions of floating versus fixed capital.

*Response:* Noted. The issue raised cannot be addressed within the current legislative cycle because any change of the kind suggested will require a further round of comment. These issues will accordingly be reconsidered for the 2011 legislative cycle.

### 3.10 Tracing waiver in the case of share-for-share listed company reorganisations (Reference: Clause 58; section 42)

*Comment:* While the proposed relaxation of standards for listed share-for-share relief is welcome, the problem has not been fully solved. For instance, listed company transferees cannot determine whether the shares transferred are gain or loss shares nor can they determine whether the transferors are domestic or foreign residents.

*Response:* Comment misplaced. The point raised is more theoretical than real. The only issue of concern for the company transferee in the case of a share-for-share transaction is the base cost of the shares received and the application of the Securities Transfer Tax. Market value

base cost treatment will apply to the shares received, and Securities Transfer Tax relief applies. The determinations raised have no bearing on these outcomes.

*Comment – Effective date:* The effective date of the proposed relief should be moved back to 1 January 2009. Many listed share-for-share reorganisations have inadvertently violated the current rules to be removed (due to their lack of commerciality).

*Response:* Not accepted. The proposed effective date will remain as initially stated. While the new relief mechanism is generally more favourable for most taxpayers, the revised regime is slightly narrower than the previous relief. Hence, retroactive application of the amendment would inadvertently have been to the detriment of some.

### 3.11 Short-Term Insurance (Reference: Clause 48; section 28)

*Comment:* The requirements of the Financial Services Board (FSB) should take precedence in determining deductible reserves. In other words, if the FSB requires a specified level of reserves, the deduction should be permitted without providing SARS with the discretion to deny or reduce the deduction.

*Response:* Noted. The objectives of the FSB are different to that of the Income Tax system. The FSB seeks to maximise reserves for the protection of policyholders; whereas, the tax system is at risk if reserves are over-funded. The FSB rules in relation to reserves are being finalized in the light of the financial crisis. The current discretion to make adjustments will accordingly remain in force until the rules are finalized.

### 3.12 Technical corrections

*Comment: (Section 64C(4)(l)):* The relief from deemed dividend treatment in the case of downward loans is too restrictive. No reason exists to deny the relief when a holding company makes a loan to a subsidiary merely because the subsidiary is part of a group of companies.

*Response:* Accepted. The prohibition was merely designed to deny relief in the case of circular structures. The reference to “group of companies” will accordingly be deleted. Taxpayers will instead be denied relief only if the borrowing subsidiary directly or indirectly holds shares in the lending holding company.

*Comment (Clause 127; section 7 of the Taxation Laws Amendment Act, 2009):* The treatment of open market buybacks on the JSE as a capital transaction versus dividend treatment is generally welcome. However, the change should not be retroactive because many transactions have already occurred on the basis that dividend treatment applied. Any change will require reversal of returns previously required under the Secondary Tax on Companies.

*Response: Accepted.* The market repurchase rule will apply prospectively as requested. The amendment seeks to assist taxpayers going forward, not to impact on previous transactions.

#### **4. INTERNATIONAL TAX**

##### **4.1 Restricting cross border interest exemption**

*(Main reference: Clause 18; section 10B)*

*Comment:* The proposal discourages foreign investment (e.g. direct foreign investment from holding companies and direct foreign investment from venture capital funds) and raises the cost of cross-border financing.

*Response: Not accepted.* Imposition of tax invariably comes down to a balancing of factors. While an exemption for cross-border interest may indeed promote certain forms of direct foreign investment, this exemption comes at a very high cost to the fiscus. Besides the obvious deadweight loss, the exemption encourages taxpayers to recharacterise equity investments as debt. The incentive also opens the door to schemes where funds flow offshore as deductible interest. At this stage, given the large sums involved, it is believed that the proposal must proceed as a matter of self-protection for the fiscus.

*Comment:* The proposal will not be effective as planned. Even if the revised domestic tax charge will be imposed as intended, many tax treaties limit the South African right to tax cross border interest to zero per cent. Therefore, the net result will merely be to shift interest flows from non-tax treaty countries to tax treaty countries.

*Response: Partially accepted.* It is accepted that a number of tax treaties will have to be renegotiated, especially with certain low tax countries. This renegotiation can only occur once the revised domestic cross-border proposal is promulgated without which South Africa has no viable negotiating position. However, it is admitted that this renegotiation process will take some time so the effective date of the proposal will be postponed to 1 January 2013.

*Comment:* If the proposal is implemented as intended, thereby creating additional tax on cross-border interest for the payee, the proposal will trigger “gross-up” clauses within existing cross-border loans. If triggered, these clauses will hurt local borrowers and increase cross-border borrowing rates in excess of current Exchange Control limits. In view of the above, the proposal should be withdrawn.

*Response: Noted.* The gross-up clauses described are common to many financing schemes influenced by tax considerations. If the fiscus were to withdraw wherever these clauses could be triggered, anti-avoidance

measures would become impossible to apply. Taxpayers utilise these clauses precisely because concerns exist that tax benefits may be at risk. Consultation is occurring with Exchange Control authorities to ensure that taxpayers are not forced into a position where the gross-up clauses result in Exchange Control violations. Again, the effective date has been delayed, providing time for Government to accommodate these concerns.

*Comment:* A withholding tax at a rate of 10 per cent makes more sense than the proposed inclusion of interest as ordinary revenue. A withholding tax is easier to enforce, avoids foreign registration and is more consistent with international practice.

*Response:* Accepted. The proposed amendment will be converted into a 10 per cent final withholding tax (with the ordinary revenue concept abandoned). The withholding regime will be patterned after the current 10 per cent withholding regime for cross-border royalties.

*Comment:* The proposed exemptions should be extended to include loans incurred by headquarter companies. Without this relief, the headquarter regime will be rendered ineffective.

*Response:* Partially accepted. The amendment will apply to headquarter companies but will be limited to back-to-back loans. Across-the-board relief would undermine the tax base of the headquarter company and could even be used as a mechanism to undermine the proposed withholding charge for other domestic entities by routing loans through the headquarter company.

*Comment:* The exemptions should extend to South African debt that is listed on foreign exchanges. Many larger South African company groups list their debt on local and foreign exchanges.

*Response:* Accepted. The proposal will be amended to exempt South African companies with listed debt on both local and foreign exchanges. Both forms of debt are equally mobile.

*Comment:* The exemptions should extend to cross-border intra-group debt. Many foreign multinational groups utilise group funding with rates set at the treasury group company level.

*Response:* Not accepted. The proposal will be rendered meaningless as the arbitrage is likely to arise in a group context. Much of this debt is merely equity in disguised form and exists in large part to undermine the tax base.

*Comment:* The Government exemption should extend to government-owned parastatals. Failure to extend the exemption will mean that the cost of indirect government funding will be increased.

*Response:* Noted. Parastatals generally receive funds that are largely tax-exempt in their home country for legitimate policy reasons. An exemption of this kind will be considered.

*Comment:* The trade finance exemption should cover interest related to incidental trade services. The exemption also should cover Export Credit Agency related-interest charges.

*Response:* Accepted. The trade finance exemption will be defined more clearly. All ordinary course trade-related finance will be covered, including interest associated with letters of credit, bills of exchange and interest charges associated with the Export Credit Agency.

*Comment:* The exemption should cover foreign bank lending, especially syndicated foreign loan arrangements. Local borrowers need access to foreign financing, especially when local financing is unavailable.

*Response:* Not accepted. Foreign borrowing will still be permissible - only taxable at 10 percent rate. No policy reason exists to provide foreign borrowings with an advantage over domestic borrowing.

*Comment:* The denial of the exemption for local branch interest should apply only for "attributable to" interest. The current force of attraction principle (i.e. the tainting of all interest merely due to the existence of a local branch) should be rejected.

*Response:* Not accepted. This aspect of the proposal merely follows existing law. If accepted, the suggestion creates significant tracing problems with taxpayers "notionally" allocating debt away from the branch.

*Comment:* The denial of the exemption applies even if the thin capitalisation rules apply (thereby resulting in a simultaneous denial of deductions for the payor). The denial of the exemption and the thin capitalisation rules should at least be co-ordinated.

*Response:* Noted. Given the fact that the thin capitalisation rules will now be linked to transfer pricing concepts, a self-co-ordinating mechanism is automatically included because the tax benefits of excessive interest are significantly reduced. As a practical matter, transfer pricing cannot be applied to impose an excessive tax charge (only to adjust the price without regard to tax as a motivating factor).

4.2 Refinement of the participation exemption  
(Main reference: Clause 17(1)(q); section 10(1)(k)(ii))

*Comment:* The proposed removal of the participation exemption in the case of interest-like preference dividends should be withdrawn or significantly narrowed. The participation exemption is not solely intended as a mechanism to encourage the repatriation of foreign dividends. The exemption is also designed to prevent double taxation caused by foreign taxes associated with underlying profits giving rise to dividends. Hence, the exemption applies in lieu of the more complex mechanism of indirect tax credits. Moreover, the proposal undermines investment in foreign countries with local ownership requirements by reducing the practical forms of foreign shares available for South African multinationals to use as a structuring device.

*Response:* Accepted. The narrowing of the exemption so as to exclude interest-like preference shares will generally be withdrawn. The existence of preference shares does not properly target the avoidance of concern while giving rise to potential cross-border double taxation as suggested. The only limit to be added by the Bill is the realignment of the definition of “foreign dividend” in line with foreign law of the country in which the foreign company is established. This change ensures that the dividends at issue are characterised by the applicable foreign country as foreign dividends (that should arguably give rise to a direct tax credit or a participation exemption) as opposed to foreign interest).

*Comment:* The proposed anti-avoidance rule seeking to prevent the circular flow of funds (e.g. funnel schemes) is too broad. As a result, these anti-avoidance rules create unintended results and may even be void for vagueness.

*Response:* Not accepted. The rules are open-ended precisely because of the various complicated forms in which circular schemes manifest themselves. These offshore schemes are often loosely linked through various special purpose vehicles and back-to-back arrangements – all of which should be captured by the broad language utilised.

*Comment:* The proposed anti-avoidance rule seeking to prevent the circular flow of funds (e.g. funnel schemes) seemingly penalises a chain of foreign dividends into South Africa. The anti-avoidance rules should only be triggered by an initial deductible payment.

*Response:* Accepted. The rule will be changed so that the anti-avoidance rule is triggered by a deductible payment to be received or accrued by a payee in exempt form. The initial deduction must be the trigger for anti-avoidance rule because the initial avoidance represents the danger to the local tax base.

*Comment:* The proposed anti-avoidance rule seeking to prevent the artificial circular flow of funds (e.g. funnel schemes) seemingly penalises the application of foreign dividends to repay local debt. This result is clearly unintended – the goal of the rules is merely to prevent deductible payments before the funds shift offshore – not after the funds return.

*Response:* Accepted. The amendment will be reworded so that the source of the deductible payment gives rise to the foreign dividend (i.e. the foreign dividend arises directly or indirectly from the deductible payment). No concern exists if foreign dividends are merely used as a source of funds to pay deductible interest on funds owed.

*Comment:* The dividend and capital gain participation exemptions should be aligned. Both rules seemingly deviate without any explicit rationale.

*Response:* Partially accepted. The rules will mirror one another more closely. The limitations on foreign dividends with debt-like characteristics will be dropped so as to remain in line with the capital gains participation exemption. The only limitation to be added is a prohibition against dividends from foreign financial instrument holding companies (which mirrors the same prohibition currently contained in the capital gains participation exemption). This form of prohibition exists in many foreign participation exemptions because the design of the exemption is to repatriate offshore profits from foreign active businesses (which typically carry a higher foreign tax burden than foreign passive income).

#### 4.3 Definition of foreign dividend

(Main reference: Clause 6(1)(e); section 1 “foreign dividend” definition)

*Comment:* The proposed definition of a “foreign dividend” is too difficult for minority shareholders to determine. Moreover, it is unclear whether the foreign law determination is applied from the perspective of the shareholders or from the perspective of the paying company.

*Response:* Comment misplaced. The proposed amendment was changed due to the concerns about the ability of minority shareholders to classify foreign distributions. Reliance of foreign tax law means that the description provided in a listed foreign company’s financial statements can be relied upon for classification. This reliance is more accessible to minority shareholders than requiring an independent South African tax classification. As to the second point, the determination is made from the perspective of the foreign company payor (thereby promoting a consistent result among shareholders).

*Comment:* How the foreign dividend definition applies in the case of foreign limited liability companies and limited liability partnerships is unclear. These

entities do not distribute “dividends” in the normal sense. The net result could be ordinary revenue without offset for foreign taxes paid on the underlying profits (i.e. amounts ineligible for the participation exemption).

*Response:* Accepted. The issues raised in relation to foreign limited liability companies and limited liability partnerships are part of a bigger issue. Despite their limited liability status, these entities should more appropriately be viewed as flow-through entities because net profit and loss is credited to the various owners as the net profit and loss arises. Hence, distributions from these entities should not be classified as company dividends but as partnership distributions. The law will be amended accordingly (with the effective date delayed until 1 October 2011 to allow for comment before implementation).

*Comment:* Although a definition now exists for foreign dividends, no definition exists for foreign capital distributions. Presumably, a definition of this nature is required as a matter of co-ordination.

*Response:* Noted. The revised mechanism for dividend determinations does in effect require two systems – a domestic company system of segregating dividends from capital distributions as well as a foreign company system of segregating dividends from capital distributions. Given the current time constraints, the definition of foreign capital distributions will be an item for consideration in the 2011 legislative cycle.

#### 4.4 Transfer pricing (Reference: Clause 53; section 31)

*Comment:* The proposed independent person test does not respect the uniqueness of group arrangements. Many pricing arrangements within a group deviate from independent arm’s length prices without regard to tax considerations.

*Response:* Not accepted. The proposed transfer pricing rules are fully in line with international concepts and guidance provided by the OECD and UN. As the 2009 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations note at 1.7; “There are several reasons why OECD member countries and other countries have adopted the arm's length principle. A major reason is that the arm's length principle provides broad parity of tax treatment for MNEs and independent enterprises. Because the arm's length principle puts associated and independent enterprises on a more equal footing for tax purposes, it avoids the creation of tax advantages or disadvantages that would otherwise distort the relative competitive positions of either type of entity. In so removing these tax considerations from economic decisions,

the arm's length principle promotes the growth of international trade and investment.”

*Comment:* The proposed re-alignment of the transfer pricing rules cannot be applied within the South African context. If true arm's length rates are used, the rates will exceed the cross-border interests rates allowed under Exchange Control.

*Response:* Not accepted. Transfer pricing is not unique within the South African context and the OECD Guidelines recognise the impact of government policies such as exchange control. Taxpayers seek to deduct substantial amounts of interest in order to reduce South African tax. Transfer pricing principles readily apply to deny the deduction of excessive interest. Moreover, Exchange Control interest limits are not “hard-and-fast”. Exceptions are made in appropriate circumstances.

*Comment:* The proposed additional power of SARS to recharacterise terms and conditions is too wide. Recharacterisation is the subject of a general anti-avoidance rule. The goal of transfer pricing is merely to re-adjust prices, not to change the stated form of the transaction.

*Response:* Not accepted. The proposed amendments are fully in line with tax treaties and other international tax principles. The power to undertake this recharacterisation is essential to reach an arm's length standard in cases that have been identified in the OECD Guidelines. If the form of the parties has to be fully accepted without question (especially if that form has been arranged to undermine the tax system) application of transfer pricing concepts becomes meaningless.

*Comment:* The transfer pricing rules should apply both ways. The stated price should be adjusted in accordance with the arm's length standard regardless of whether the recharacterisation favours SARS or the taxpayer. Therefore, the tax benefit requirement should be deleted.

*Response:* Not accepted. Taxpayers cannot use the rules to re-adjust price in their favour when they have the freedom to initially set the terms and conditions of the transaction, including price.

*Comment:* How does one apply the proposed transfer pricing rules? Do taxpayers treat transfer pricing as a self-adjustment or do the rules require SARS intervention?

*Response:* Accepted. Taxpayers are required to account for transfer pricing on an arm's length basis. The rules essentially follow a self-adjusting route without required SARS intervention.

*Comment:* Current law treats all transfer pricing underpayments as a deemed dividend (in addition to the pricing realignment). This additional charge does not reflect OECD practice and makes transfer pricing adjustments somewhat penal. This excessive charge effectively extends the dispute process because taxpayers are reluctant to accept this double charge.

*Response:* Not accepted. The deemed dividend is a secondary adjustment, as discussed in Chapter IV of the OECD Guidelines. Taxpayers are treated on the basis that the misallocation of price resulted in funds being distributed offshore. For instance, assume a domestic subsidiary sells inventory to a foreign holding company for R100 when the real value is R180. Under these circumstances, the transaction should be treated as if the foreign subsidiary sold the inventory for R180 (generating an additional R80 of gross income) followed by a deemed dividend of R80 (because the domestic subsidiary no longer holds the R80 that the domestic subsidiary should have earned).

*Comment:* The effective date of the proposed change to the transfer pricing rules should be delayed so as to provide taxpayers with time to fully consider the ramifications of the change. The proposed change should also not disturb pre-existing arrangements.

*Response:* Partially accepted. The effective date will be moved to 1 October 2011 due to the required changes to existing SARS practice / interpretation notes. However, non-application of the new rules to pre-existing arrangements is rejected because taxpayers are essentially seeking fiscal stability protection.

4.5 Thin capitalisation in respect of South African branches of foreign companies  
(Main reference: Clause 53: Section 31)

*Comment:* The revised thin capitalisation rules create a potential conflict with the non-discrimination requirements of tax treaties. The rules should be modified to eliminate this conflict.

*Response:* Comment misplaced. The amendments are precisely motivated to align with the thin capitalisation rules as applied within a tax treaty context. International principles fully recognise the thin capitalisation concept as a subset of transfer pricing.

*Comment:* The proposed thin capitalisation rules for domestic branches of foreign companies are not properly linked. The proposed rules improperly

measure excessive debt only from the perspective of the foreign company as a whole - not from the perspective of the local branch.

*Response:* Not accepted. Attribution of loan capital to a branch is difficult to apply because the branch itself is not a legal entity. Contractual rules apply only at entity level. Hence, any allocation would be notional. This notional allocation would be especially difficult to enforce in the case of financial instruments given the fungible nature of funds.

*Comment:* The proposed change to the thin capitalisation rules will unsettle the validity of Practice Note 2 (including the 3:1 rule). Additional time is required to realign Practice Note 2.

*Response:* Noted. The concerns raised are an issue for interpretation. SARS will accordingly update the Practice Note before the provision comes into effect. As discussed above, this amendment will accordingly be delayed until 1 October 2011.

#### 4.6 Regional holding company regime

*(Main reference: Comment (Clause 6(1)(j); section 1 "headquarter company" definition)*

*Comment:* The 20 per cent minimum shareholder requirement wrongly excludes headquarter companies that are listed on various exchanges.

*Response:* Not accepted. The amendment is only intended to cover regional subsidiaries. Moreover, the 20 per cent minimum requirement is designed so that the headquarter standard is placed on par with the 20 per cent minimum requirement of the foreign participation exemption.

*Comment:* The 20 per cent minimum shareholder requirement is too high. The requirement effectively disallows the use of headquarter shares as compensation for key employees or as a mechanism for black economic empowerment.

*Response:* Not accepted. As a practical matter, employees do not want minority share interests in a holding company. Minority shares have little value especially if the majority of shares are held by a single party. Moreover, regional subsidiaries do not generally allow for small minority shareholdings because the minority complicates the cross-border flow of funds.

*Comment:* The 80 per cent foreign qualifying asset minimum is too high. The requirement prevents substantial cash/liquid holdings. These holdings may be especially problematic when cash/liquid funds are amassed for acquisitions or as a result of disposals.

*Response:* Comment misplaced. The calculation is done only at year-end. Funds will typically be placed in the headquarter company only once

the funds are directed toward a specified use. Therefore, taxpayers will not typically find themselves with idle cash, and even if taxpayers find themselves in this position, they can easily move the excess funds out of the company before year-end without adverse tax consequences.

*Comment:* Favourable treatment (i.e. positive inclusion in the numerator) of 20 per cent or greater share ownership in foreign subsidiaries is welcomed. While this treatment properly includes loans to the same foreign subsidiaries, the proposal improperly excludes licenses and other intangible agreements.

*Response:* Accepted. Intellectual property licensed by the headquarter company to a 20 per cent (plus) foreign subsidiary will now be treated favourably. The goal is to allow for a free flow of capital to the foreign subsidiary in whatever form.

*Comment:* Reliance on “base cost” as the 80 per cent measurement tool is cumbersome. The use of “cost” or “actual cost” is preferred instead.

*Response:* Accepted. The term “cost” will be used instead of base cost as requested. The goal is to simplify compliance and enforcement as much as possible in order to enhance the success of the proposed headquarter company regime.

*Comment:* The 20 per cent foreign shareholder determination within the 80 per cent asset test appears to have an anomaly. The rules appear to exclude a 20 per cent or greater foreign shareholding merely because the headquarter company owned a lesser percentage at a prior date. Presumably, the 20 per cent foreign shareholding minimum should be determined on a yearly basis without reference to prior years.

*Response:* Accepted. The 80 per cent asset test will be determined on a year-by-year basis. Prior-year lower percentages will not count against taxpayers.

*Comment:* The 80 per cent qualifying income test should treat all foreign income derived from 20 per cent or greater foreign subsidiaries as qualifying income. However, the current version of the test only treats certain forms of income (such as interest and dividends) within the favourable category while other forms are implicitly excluded (such as guarantee fees).

*Response:* Accepted. All fees paid or payable by qualifying foreign subsidiaries will be counted favourably. The goal again is to provide flexibility for various forms of commercial arrangements.

*Comment:* The uninterrupted compliance restriction is too harsh. Failures to satisfy the regime result in permanent loss of headquarter status. This rule is especially problematic in respect of the 80 per cent income requirement. Income

of the headquarter company can easily vary due to forces outside the headquarter company's control, especially during periods of economic distress.

*Response:* Partially accepted. The income test will be measured only on a yearly basis due to the lack of taxpayer control as discussed above. The other two tests will remain subject to the uninterrupted compliance test. Taxpayers should not be able to restructure pre-existing company relationships outside the objective solely to fall within relief measures. The goal is to attract new forms of investment.

*Comment:* If one or more foreign subsidiaries of a headquarter company have controlled foreign company status, the current section 9D attribution rules trigger income for the headquarter company. This result is problematic for foreign shareholders of a headquarter company because these shareholders are indirectly bearing some of the tax on the section 9D income. If controlled foreign company status exists in respect of a foreign subsidiary, section 9D attribution should instead apply to the shareholders of the headquarter company.

*Response:* Accepted. Attribution will be changed so that any section 9D attribution required will fall on the resident shareholders, not the holding company itself.

*Comment:* The proposed headquarter company relief from the thin capitalisation rules is too narrow. Firstly, the proposed thin capitalisation relief only covers back-to-back loans. Secondly, any losses resulting from the arrangement are ring-fenced.

*Response:* Not accepted. Taxpayers should not be able to use excessive interest to eliminate otherwise taxable South African income. The relief is designed solely to ensure that the headquarter company will allow a free flow of debt capital to and interest from foreign subsidiaries.

*Comment:* Dividends from headquarter companies should be exempt like all other domestic dividends. The treatment of headquarter company dividends as having foreign dividend status is an unnecessary complication.

*Response:* Not accepted. The headquarter company should be placed on par with foreign company dividends because foreign subsidiary profits should act as the originating source of the bulk of the headquarter company profits. The foreign dividend participation exemption also contains the anti-circular scheme avoidance rule needed to protect the tax base.

*Comment:* The proposal should contain the same benefits as a Mauritius GBL (i.e. a complete exemption). The relief must be on par with Mauritius in order to compete effectively within the global market.

*Response:* Not accepted. Regimes similar to the GBL are deemed to be a harmful tax practice. The goal is to have a regime that entices foreign investment without South Africa being accused of harmful tax practices.

*Comment:* Foreign exchange gains of a headquarter company should be exempt. Headquarter companies often utilise various forms of foreign currency due to the multiple cross-border nature of the activities involved (i.e. due to their regional holdings).

*Response:* Partially accepted. If the headquarter company has a different functional currency than the Rand, the functional currency will act as the starting point for foreign currency tax calculations. This revised starting point should simplify their currency tax calculations.

*Comment:* Management fees/royalties of the headquarter company should be exempt so that the regime reflects a headquarter company as opposed to a mere holding company.

*Response:* Not accepted. The proposed exemption may ultimately be viewed as undermining locally-based South African multi-nationals providing the same foreign subsidiary management services. The purpose of the proposal is merely to eliminate the unique extra tax hurdles for foreign-derived South African regional operations.

*Comment:* Management fees earned by South African residents are often subject to double taxation when those fees relate to African operations. Many African countries seek to tax these fees even though the services occur within South Africa. Therefore, section 6quat credits should be available to prevent double taxation, especially in relation to headquarter companies.

*Response:* Not accepted. The services mentioned are sourced within South Africa so South Africa should accordingly have the first taxing right. The issue raised is primarily of concern where no double taxation agreement is in place and goes beyond the headquarter company regime, having an impact on all South African taxpayers that manage foreign African operations. In order to assist South African taxpayers, while maintaining accepted principles, the Act was amended in 2007 to permit the deduction of foreign tax under these circumstances.

4.7 Regional investment fund regime  
(Main reference: Clause 6(1)(q); section 1 “permanent establishment” definition)

*Comment:* The regime must be adjusted to cover foreign limited liability companies and foreign limited liability entities. Without change, both of these structures may have a taxable permanent establishment (and even deemed local effective management) within South Africa, thereby triggering tax. This form of taxation will prevent local management of foreign-owned private equity concerns

because most of these foreign-owned concerns prefer to utilise foreign limited liability companies and foreign limited liability partnerships.

*Response:* Partially accepted. As discussed above, the new foreign limited liability company and foreign limited liability partnerships rules will impose flow-through treatment for entities if this treatment prevails under the foreign tax law in which the entity is established. This flow-through treatment will automatically place these foreign limited liability companies or limited liability partnerships on par with domestic partnerships, thereby indirectly eliminating the issues raised.

*Comment:* The relief must be expressed as an outright exemption for investor comfort.

*Response:* Not accepted. The rules seek to blend into current core concepts. A flat exemption is likely to come under scrutiny as a harmful tax practice.

#### 4.8 Reporting in multiple currencies

*(Main reference: Clause 6(1)(f); section 1 “functional currency” definition)*

*Comment:* Taxpayers should be given the choice of relying upon their reporting currency or a functional currency as their base currency for tax purposes. The current proposal merely shifts the base currency from a reporting focus to a functional currency focus.

*Response:* Not accepted. The proposal is based on requests by taxpayers with offshore operations. The term “functional currency” is designed to eliminate the uncertainty caused by the “reporting currency” concept. No reason exists to retain the uncertainty as a choice.

*Comment:* The term “functional currency” needs to be defined. The imprecise nature of the definition causes uncertainty.

*Response:* Partially accepted. The term is defined in general terms and be clarified by interpretation. The aim is to keep the definition somewhat flexible to cover the various forms of offshore operations.

#### 4.9 Abandoned hyper-inflationary currencies

*(Main reference: Clause 95; paragraph 43B of the 8th Schedule):*

*Comment:* The proposed relief for abandoned currencies should include currencies that are of no practical use, even if not actually abandoned.

*Response:* Not accepted. The relief is limited to abandoned currencies because the dividing line is clear. Currencies with rapidly declining

values (i.e. hyperinflationary currencies) are already covered in a different (but more limited) way.

*Comment:* The proposed relief should cover all income and loss arising within a controlled foreign company, not just the amount relating to the controlled foreign company's permanent establishment.

*Response:* Accepted. All the calculations will be covered by the revised rules as requested.

*Comment:* The cost rules for currency must assume a new functional starting currency when a new currency is utilised (in place of the abandoned currency). The rules should not just assume a new value.

*Response:* Accepted. A new starting date and tax cost rule will apply as if the affected assets were acquired in the new financial reporting currency. The rule will apply solely to controlled foreign companies because the branch calculations should have been ongoing.

*Comment – Effective date:* The proposed relief should be back-dated to 1 January 2009. Shortly after this date the Zimbabwe dollar was abandoned.

*Response:* Accepted. The date will be adjusted in light of recent past events.

## **5. MINERAL AND PETROLEUM RESOURCES ROYALTY**

### **5.1 The definition of “wins or recovers”**

*(Reference: Clause 115(1)(d); section 1 “wins or recovers” of the Mineral and Petroleum Resources Development Act, 2008)*

*Comment:* The proposed definition of “wins or recovers” should be deleted. The definition does not resolve the stockpile issue as intended and also creates unintended consequences.

*Response:* Accepted. The proposed definition will be deleted. The stockpile issue will be addressed via the rollover relief provisions (see below).

### **5.2 Rollover relief for domestic refining**

*(Main reference: Clause 119; section 8A of the Mineral and Petroleum Resources Royalty Act, 2008)*

*Comment:* Rollover relief should be allowed regardless of whether a refining purpose exists for the transferee.

*Response:* Accepted. Purpose will no longer be a qualifying requirement for rollover relief. Both parties must simply agree to the rollover.

*Comment:* Unregistered parties should be eligible transferees for rollover relief. Many parties without mineral rights may seek to refine mineral resources or otherwise participate in the value chain.

*Response:* Accepted. Parties will be permitted to elect into royalty registration. This election will effectively make the parties eligible to act as a royalty rollover transferee.

*Comment:* Multiple rollovers should be allowed. Mineral resources may pass through multiple hands before reaching manufacturing stage.

*Response:* Accepted. Multiple rollovers will be allowed with one caveat. Parties electing into the royalty solely to benefit from rollover relief will not be eligible for rollover relief when subsequently transferring mineral resources to other parties. This caveat is designed to prevent an endless string of rollover agreements solely to defer the royalty.

### 5.3 Mineral resources with specified condition ranges

*(Main reference: Clause 118; section 6A of the Mineral and Petroleum Resources Royalty Act, 2008)*

*Comment:* No justification exists for coal to be categorized into four grades. At most, coal used by Eskom falls into grades D and C. No reason also exists for using the “in situ” language to classify coal.

*Response:* Accepted. The current coal definitions are confusing and give rise to unintended anomalies. The proposed specified condition for coal will become “run of mine” with a minimum of 19 MJ/kg. If coal is mined above the 19 MJ/kg level, the royalty will apply at the level mined. If beneficiation/value addition drives coal above the 19 MJ/kg level or the mined level, whichever is the highest, the beneficiation/value addition will be subtracted from the royalty calculation.

*Comment:* The current specified condition in Schedule 2 for mineral sands is incorrect. These conditions do not reflect local market conditions.

*Response:* Accepted. The rates for rutile, zircon and ilmenite will be adjusted. The rates for rutile will be changed from a 53 per cent minimum to a 71 per cent minimum. The rates for zircon will be adjusted from a 85 per cent minimum to a 90 per cent minimum. The rates for ilmenite will be adjusted from a 75 per cent minimum to an 80 per cent minimum.

*Comment:* The specified condition range of 61-to-64 per cent Fe content for iron ore inadvertently taxes beneficiation. Iron ore is often mined at a 61.5 per cent level with beneficiation processes utilised to increase the level up to a 65 per cent Fe content. This increase requires expensive plant beneficiation processes.

*Response:* Accepted. The range for iron ore will be deleted. The schedule will be revised in line with the revision for coal. The proposed specified condition for iron ore will become “plant feed” with a minimum of

61.5 per cent Fe content. If iron ore is mined above the 61.5 per cent level, the royalty will apply at the level ready to be fed into the plant. If beneficiation/value addition drives iron ore above 61.5 per cent Fe content level or the mined Fe content level, whichever is the highest, the beneficiation/value addition will be subtracted from the royalty calculations.

#### 5.4 Technical correction

*Comment (sections 5 and 6 of the Mineral and Petroleum Resources Royalty Act):* The “gross sales” amount should take into account the differences between amounts received versus amounts accrued that stem from foreign exchange rate fluctuations. The earning before interest calculation should similarly allow for currency losses of the same type.

*Response: Accepted.* The royalty should ultimately be based on total amounts eventually received if those amounts differ from amounts accrued. These differences (both positive and negative) should be taken into account as these differences arise.

## 6. **CO<sub>2</sub> VEHICLE EMISSIONS TAX (OUTSIDE THE AMENDMENT BILLS)**

*Comment:* The motor industry has raised an objection to the inclusion of double cabs and small bakkies as passenger vehicles. They are of the view that these vehicles are classified as light commercial vehicles and should at this stage be excluded from the CO<sub>2</sub> vehicle emissions tax. The industry also asserts that emissions data for light commercial vehicles are not available, the main reason why we originally agreed to refer to passengers vehicles only.

*Response: Not Accepted.* It was always the intention that double cab vehicles should be included in the group of vehicles that will be subject to the CO<sub>2</sub> vehicle emissions tax during the first phase of its implementation. The inclusion of double cabs as a passenger vehicle is also in line with the intent of the VAT Act, the practical reality being that double cabs are mainly used as passenger vehicles. The inclusion is also in line with the original intent of the then Department of Minerals and Energy to tax gas guzzlers (like double cabs these cabs tend to be used as passenger vehicles and have relatively large engines that are not the most fuel efficient). The National Regulator for Compulsory Specifications, a subsidiary of the SABS, has confirmed that CO<sub>2</sub> emissions expressed as g/km is available for all vehicles. In addition, it might be possible to use engine size as a proxy to derive vehicle CO<sub>2</sub> emissions. The request by the industry to exclude double cabs and small bakkies from the vehicle CO<sub>2</sub> emissions tax should therefore not be accepted. Most small single cab bakkies and their double cab equivalents in relation to one another have similar engine sizes. Therefore, these two categories of vehicles should be treated the same for the purpose of the vehicle CO<sub>2</sub> emissions tax.

## 7. ADMINISTRATIVE ISSUES

### 7.1 Voluntary Disclosure Program (VDP)

(Main reference: Clause 1 to 11)

*Comment:* Principal legislation in the form of the VDP should not be contained in an amendment Act. Legislation contained in amendment Acts are not consolidated in any of the publications when amendments are made thereto making it difficult to ensure that relevant stakeholders are working with the correct version of the legislation.

*Response:* Not accepted. The current framework for the VDP is a temporary framework, with a specific window period. If a permanent framework for the voluntary disclosure program is to be introduced it will be contained in the Tax Administration Bill.

*Comment:* Clause 1 – Definition of “**default**”: The definition of “default” contains a reference to the “correct amount of tax”. However, this concept is not defined and in order to ensure certainty this phrase should be defined.

*Response:* Not accepted. A “default” is defined to include a situation where the submission of inaccurate or incomplete information to the Commissioner, or the failure to submit information or the adoption of a tax position, where such submission, non-submission, or adoption resulted in the correct amount of tax not being paid by the taxpayer. Since the VDP covers a broad range of taxes, the question of whether or not the correct amount of tax has been paid would be determined by the legislative framework applicable to the relevant set of facts.

*Comment:* Clause 4(e): One of the requirements for a valid voluntary disclosure is that the disclosure must not result in a refund due by the Commissioner (clause 4(e)). It is noted that this requirement may disincentivise taxpayers who wish to apply for relief as a result of late submission of their returns, where such taxpayers has a refund due by SARS but face substantial penalties as a result of the late submission.

*Response:* Comment misplaced. VDP relief is not available for penalties on the late submission of returns. Administrative and other penalties have been introduced and collection initiatives instituted to compel submission of returns. These steps would be undermined by including penalties for the late submission of returns in the VDP.

*Comment:* Clause 4(h): It is submitted that the requirement defaults must have occurred more than 12 months before the VDP opens makes the eligibility criteria for relief too restrictive. If a default is discovered within the 12 months, there seems to be no reason why the taxpayer cannot apply for relief in that instance as well. Alternatively, as the Minister informed taxpayers of the proposal to introduce the Voluntary Disclosure Program in his Budget Speech presented to Parliament on 17 February 2010, it is submitted that there is no reason why defaults which occurred prior to the date of the announcement should not be capable of being regularised under the proposed legislation.

*Response:* Accepted. Defaults before the announcement of 17 February 2010 will be considered for the VDP. A cut-off date is necessary to prevent taxpayers deliberately engineering non-compliance to take advantage of the VDP.

*Comment: Clause 4(h):* The 12 month-period is cumbersome in that it does not coincide with the income tax year of assessment of taxpayers and would appear to be an arbitrary period linked to the date on which the VDP program commences i.e. 1 November 2010. It is proposed that the reference should rather be made to a specific date, namely, 28 February 2010, which would cater for a large number of taxpayers by ensuring that the default coincides with taxpayer's year of assessment.

*Response:* Partially accepted: The VDP also covers taxes other than income tax. It is, however, proposed to amend the cut-off date to coincide with the announcement of the VDP on 17 February 2010.

*Comment: Clause 5.* Proposed that the no-name approaches should be eligible for a binding ruling on the applicability of the VDP (but without having to go through all of the processes one normally has to go through for a binding ruling). Getting finality on a no-names basis before disclosing the applicant's identity would enhance the attractiveness of making voluntary disclosure. It is the method used, e.g. in Canada.

*Response:* Not accepted: Taxpayers who are unsure that they want to proceed with a disclosure are given an opportunity to participate in preliminary discussions about their situation on a no-name basis. These discussions are informal, non-binding, and general in nature and are done before the identity of the taxpayer is revealed. They are for the benefit of the taxpayer and are intended to provide insight into the VDP process, a better understanding of the risks involved in remaining non-compliant, and the relief available under the VDP.

The opportunity for no-name disclosure in a VDP is limited internationally according to the information available to SARS. Excluding South Africa, 4 out of 38 jurisdictions surveyed offered such an opportunity. According to the survey Canada and one other jurisdiction offer a form of binding no-name disclosure. The following passages from the Canada Revenue Agency's information circular IC00-1R2 of 2007 are, however, relevant; "27... If all the required information for a complete disclosure, except for the identity of a taxpayer, has been submitted the CRA can also review, upon request, this preliminary information and advise, *without prejudice*, on the possible tax implications of the disclosure." and "28. The CRA can undertake to provide a final and determinative decision on a no-name disclosure only after the identity of the taxpayer is known and all facts of the disclosure, in respect to the four validity conditions (paragraphs ¶31 to ¶42), have been verified." (Emphasis added.)

*Comment:* Clause 8. The decision of the Commissioner to withdraw any relief granted in terms of the VDP, is subject to objection and appeal or internal review. It is proposed that the concept of 'internal review' should be defined.

*Response:* Accepted. The concept of an "internal review" is defined in the Customs and Excise Act, 1964, and it is proposed that the opening words of clause 1 of the Bill be amended to import terms defined in a tax act for purposes of the part of the Bill dealing with the VDP and not only clause 1 of the Bill.

## 7.2 Additional information in application for advance tax ruling

*Comment:* Clause 15. Residency requirements (e.g. Permanent Establishment or Place of Effective Management), for foreign entities differ significantly from the 'enterprise' requirement as per the Value-Added Tax Act, 1991. By imputing the advance tax ruling requirements per the Income Tax Act, 1962, into VAT legislation, it would seem that vendors would now be required to register for income tax before the vendor would be able to apply for rulings.

Further, the proposed amendment seems to make the advance tax ruling procedure inaccessible to potential non-resident investors who wish to make use of the advance tax ruling procedure to determine their tax status should they make an investment in South Africa.

*Response:* Accepted. The proposed amendment has been clarified to confirm that the registration requirement refers only to a tax for which the applicant is liable under a tax Act. The proposed requirement will not apply if the basis of the ruling is to determine whether or not the applicant must register for tax under a particular tax Act (i.e. to determine the applicant's tax status).

## 7.3 Interest on underpayments and overpayments of provisional tax

*Comment:* Clause 17: Section 89*quat*(3) allows the waiving of interest when a taxpayer has underpaid provisional tax because he has claimed a deduction or allowance or has excluded an amount from income on reasonable grounds. The third 'top-up' provisional tax payment is based on an estimate of taxable income made by a taxpayer who needs to make certain assumptions in doing the calculation, e.g. whether or not an amount is of a capital or revenue nature. In these instances, where the taxpayer has reasonable grounds to contend that the amount was not taxable, it would be appropriate for SARS to waive interest. This is particularly so given that the interest levied is effectively a penalty, such interest being levied at market-related rates and not being deductible for tax purposes.

Also, the Commissioner's discretion to remit interest in terms of section 89*quat*(3) is a methodology of expediting settlement. Removal of this discretion will lead more matters to go before the High Court where the taxpayer has a reasonable belief that the amounts are in fact deductible rather than a commercial settlement

whereby both parties lose something in the transaction in order not to only enrich lawyers in the legal process.

*Response:* Partially accepted. Whether the taxpayer had reasonable grounds for the position taken or not, the fact remains that the taxpayer had the use of money due to the *fiscus*. Additional tax or penalties are a separate issue and can be as high as 200% of the tax due, if tax evasion with no extenuating factors has taken place. The question of whether a taxpayer had reasonable grounds for the position taken is a relevant factor in determining whether and what additional tax or penalties are due. That said, a discretion to cater for circumstances outside the taxpayer's control similar to the provisions of the Value-Added Tax Act, 1991, is proposed.

If a waiver of interest is required to arrive at a commercial settlement, this should take place in terms of the settlement provisions contained in the Act and reported to the Auditor-General and Parliament, as provided for in those provisions.

#### 7.4 PAYE on Employer-provided motor vehicles

*Comment:* Clause 18(1)(b): Whilst the relief for individual taxpayers is expected to be useful and reduce administration for both those individuals and SARS, the bulk of the administrative benefit to be achieved would, we suggest, lie in eliminating the need for returns for dormant companies. The exemption should further be extended to intermediate holding companies who receive only exempt dividend income.

*Response:* Not accepted. An intermediate holding company holds assets and receives income (even if exempt) and so cannot be considered to be dormant. The question of whether dormant companies should be exempt from provisional tax is a broader question, which will be considered as part of SARS's modernisation process.

#### 7.5 Withholding or deduction of PAYE from remuneration in the form of gains on marketable securities, qualifying equity shares and equity instruments

*Comment:* Clause 19: Proposed amendment appears to make non-resident persons, who have no representative employer in South Africa, liable for employees' tax withholding. Main concerns are why this differential treatment on share schemes when the same policy should then be applied to normal employment income. The reality of SARS enforcing against a person with no legal standing in SA, the conflict which arises with other provisions of the Fourth Schedule and SARS administration which does not allow a non-resident employer to register for employees' taxes in SA. It should also be considered that where a foreign employer has an employee in SA, with no representation in SA, the offshore employer should, mostly, already fall within the SA corporate tax network, lead to registration as an external company under the Companies' Act,

which requires a public officer, and which then meets the “representative employer” definition.

*Response: Not accepted.* Paragraph 11A deems the gains made on marketable securities, qualifying equity shares and equity instruments to be remuneration payable by the person who grants the right to acquire or from whom these assets are acquired and effectively places the obligation to collect employees’ tax on such persons. In South Africa share options schemes or similar schemes which grant instruments on which gains are made, which fall within this paragraph, are overwhelmingly granted by trusts which are set up by employers to administer and finance these schemes. As these trusts do not have any cash remuneration payable to employees or cash monies from the cession release or sale of the rights or disposal of the equity instruments, they in many cases cannot withhold the employees’ tax. The tax has, therefore, to be collected on assessment which results in a delay in the collection of the tax and at times in hardship in collection because the amounts can be large. The proposed amendment places the onus of collecting the tax jointly and severally on the share trust and the employer, the latter of which normally has cash remuneration from which the employees’ tax can be withheld.

In the case of overseas share option schemes the foreign holding company normally has a foreign share option trust which grants the rights to employees of the South African subsidiary employed in South Africa. The difficulty of collection of the employees’ tax from the overseas trust is compounded by the fact that it does not have a presence in South Africa and cannot be appointed as a representative employer to collect the tax. The proposed amendment makes the South African subsidiary jointly and severally liable for the employees’ tax which can then be withheld from cash remuneration owing to the employee. The suggestion in the comment that the foreign employer should register as an external company in terms of the Companies Act and then be required to withhold the employees’ tax is not practical. It does not work because, firstly, the share options are granted by overseas trust which cannot register in terms of the South African Companies Act and, second, the foreign holding company does not have a “place of business” in South Africa which is a requirement of the Companies Act.

#### 7.6 Penalty on late rendition of returns by employers

*Comment:* Clause 22: If the administratively punitive provision for the non-payment and/or non-rendition of an employees’ tax return are meant to be housed exclusively in the Regulations under section 75B of the Income Tax Act, 1962, then the analogous penalty provisions in the Fourth Schedule should be deleted.

*Response: Noted.* As stated in SARS’s media release of 14 October 2009, the switch to administrative penalties under section 75B is taking place on a phased basis.

## 7.7 Recovery of PAYE from employers on undervaluation of fringe benefits

*Comment:* Clause 23: The proposed amendment should contain a reference to the fact that the notice of assessment is to be issued in terms of paragraph 12 of the Fourth Schedule. By referring to paragraph 12 of the Fourth Schedule the necessary link with the mechanics of the Fourth Schedule will be created, which provides the mechanism via paragraph 5 for the employer to recover the amounts of employees' tax from the employee and to reissue a tax certificate to the employee.

*Response:* Accepted.

*Comment:* Clause 23: SARS has a statutory duty to collect the tax from the employee and the proposed choice should not create an easy mechanism of collecting the tax from the employer without reference to the employee. The rights of employers and the fact that employers are assisting in the administration of the Act need to be recognised. Employers require reassurance that the SARS, for administrative considerations, will only hold the employer responsible for the tax in appropriate circumstances. Placing the responsibility for the tax ultimately on the shoulders of the employee, who enjoyed the fringe benefit, will encourage/force employees to bring correct valuations of fringe benefits to the attention of employers.

*Response:* Noted: Employees' tax is a withholding tax at the point of payment of remuneration. If an employer has undervalued a fringe benefit the employer generally has the opportunity to recover the underpayment of employees' tax from the employee. SARS can only recover underpayment from the employee upon assessment. SARS has no assurance that the employee would be able to pay the outstanding PAYE upon assessment.

*Comment:* Clause 23: Where an employer cannot recover the amount of employees' tax (resulting from the undervaluation of a fringe benefit) from the employee, paragraph 5(5) of the Fourth Schedule deems this amount to be a penalty payable by the employer. The deemed penalty does not qualify as a tax deduction in terms of section 23(d) of the Income Tax Act, 1968. Consideration should be given to allow the deemed penalty as a tax deduction in appropriate circumstances (i.e. no intention on the part of the employer to evade his obligations under the Act) as the employees' tax amounts to additional remuneration paid to the employee.

*Response:* Not accepted. A deemed penalty, like any other penalty, serves to instill a broader culture of compliance amongst taxpayers. Allowing the penalty as a tax deduction not only creates a perception of condoning the administrative failure but more importantly it reduces the effect of the penalty substantially.

*Comment:* Clause 23: SARS may also impose a penalty in terms of paragraph 17(4) of the Seventh Schedule. Potential of levying a double penalty should be reconsidered. The penalty provisions in paragraph 17 should be excluded where SARS' has raised an employees' tax assessment on the employer in terms of the proposed amendment.

*Response:* Not accepted: The principle of levying a penalty is to instill compliance with the provisions of a particular part of the law. It is possible that a single failure by an employer affects different parts of the law and as such will trigger more than one penalty at the same time.

However, in instances where the penalty in terms of paragraph 17(4) of the Seventh Schedule is imposed, SARS has the discretion to remit the whole penalty if satisfied that there was no intent by the employer to evade its obligations under the Act.

*Comment:* Clause 23: The problem with the proposed amendment is that it does not require of SARS to issue the assessment within the year of assessment that the "untaxed" benefit was enjoyed. In practice it is impossible for the small business or the employee to get an answer from SARS regarding a valuation of a benefit as is required by paragraph 3(3) of the Seventh Schedule. Hence, it is proposed that that consideration should be given to create a mechanism for the employer to approach SARS for certainty prior to the withholding of employees' tax.

*Response:* Not accepted: In practice the overwhelming majority of employers have no difficulty in determining the value of a taxable benefit and paying the right amount of tax to SARS. Guidelines and instructions are available to employers in this regard, noticeably the Guide to Employers that is available on the SARS website.

*Comment:* The amendment does also not allow for the employee to be given the benefit for the so-called unpaid amount of employees' tax.

*Response:* Comment misplaced: Employees' tax that was recovered from an employee and reflected on an IRP5 is taken into account on assessment of the employee.

7.8 Alternative documentation where vendor did not obtain/retain valid tax invoice to substantiate input tax deduction

*Comment:* Clause 29: Clarity is sought on what the nature of the 'alternative' documents that would be acceptable to SARS.

*Response:* Accepted: The documentation that will be acceptable to the Commissioner will be clarified in an updated issue of Interpretation Note

49, which sets out the documentary requirements for the purposes of section 16(2) of the VAT Act.