NATIONAL TREASURY

REPUBLIC OF SOUTH AFRICA

EXPLANATORY MEMORANDUM

ON THE

DRAFT TAXATION LAWS AMENDMENT BILL, 2011

DRAFT
02 JUNE 2011

[W.P. –- ‘11]

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Not exceeding R140 000	18 per cent of the taxable income
Exceeding R140 000 but not exceeding R221 000	R25 200 plus 25 per cent of amount by which taxable income exceeds R140 000
Exceeding R221 000 but not exceeding R305 000	R45 450 plus 30 per cent of amount by which taxable income exceeds R221 000
Exceeding R305 000 but not exceeding R431 000	R70 650 plus 35 per cent of amount by which taxable income exceeds R305 000
Exceeding R431 000 but not exceeding R552 000	R114 750 plus 38 per cent of amount by which taxable income exceeds R431 000
Exceeds R552 000	R160 730 plus 40 per cent of amount by which taxable income exceeds R552 000

Table II: Proposed rates for individuals and special trusts:

Taxable income	Rate of tax
Not exceeding R150 000	18 per cent of taxable income
Exceeding R150 000 but not exceeding R235 000	R27 000 plus 25 per cent of amount by which taxable income exceeds R150 000
Exceeding R235 000 but not exceeding R325 000	R48 250 plus 30 per cent of amount by which taxable income exceeds R235 000
Exceeding R325 000 but not exceeding R455 000	R75 250 plus 35 per cent of amount by which taxable income exceeds R325 000
Exceeding R455 000 but not exceeding R580 000	R120 750 plus 38 per cent of amount by which taxable income exceeds R455 000
Exceeds R580 000	R168 250 plus 40 per cent of amount by which taxable income exceeds R580 000

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

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

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All taxable income	28 per cent of the taxable income

Table V: Current rates for small business corporations:

Taxable Income	Rate of Tax
Not exceeding R54 200	0 per cent of taxable income
Exceeding R54 200 but not	10 per cent of the amount by which the taxable

exceeding R300 000	income exceeds R54 200
Exceeding R300 000	R24 580 plus 28 per cent of the amount by which the taxable income exceeds R300 000

Table VI: Proposed rates for small business corporations

Taxable income	Rate of tax
Not exceeding R59 750	0 per cent of taxable income
Exceeding R59 750 but not exceeding R300 000	10 per cent of amount by which taxable income exceeds R59 750
Exceeding R300 000	R24 025 plus 28 per cent of amount by which taxable income exceeds R300 000

Table VII: Current rates for registered micro businesses:

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

Table VIII: Proposed rates for registered micro businesses

Taxable turnover	Rate of tax
Not exceeding R150 000	0 per cent of taxable turnover
Exceeding R150 000 but not exceeding R300 000	1 per cent of amount by which taxable turnover exceeds R150 000
Exceeding R300 000 but not exceeding R500 000	R1 500 plus 2 per cent of amount by which taxable turnover exceeds R300 000
Exceeding R500 000 but not exceeding R750 000	R5 500 plus 4 per cent of amount by which taxable turnover exceeds R500 000
Exceeding R750 000	R15 500 plus 6 per cent of amount by which taxable turnover exceeds R750 000

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

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All taxable income	33 per cent of taxable income

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

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

Table XV: Proposed retirement fund lump sum withdrawal benefits:

Taxable income from lump sum benefits	Rate of tax
Not exceeding R22 500	0 per cent of taxable income
Exceeding R22 500 but not exceeding	18 per cent of taxable income

R600 000	exceeding R22 500
Exceeding R600 000 but not exceeding R900 000	R103 950 plus 27 per cent of taxable income exceeding R600 000
Exceeding R900 000	R184 950 plus 36 per cent of taxable income exceeding R900 000

Table XVI: Current rates for retirement lump sum benefits:

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

Table XVII: Proposed retirement lump sum benefits

Taxable income from lump sum benefits	Rate of tax
Not exceeding R315 000	0 per cent of taxable income
Exceeding R315 000 but not exceeding R630 000	R0 plus 18 per cent of taxable income exceeding R315 000
Exceeding R630 000 but not exceeding R945 000	R56 700 plus 27 per cent of taxable income exceeding R630 000
Exceeding R945 000	R141 750 plus 36 per cent of taxable income exceeding R945 000

Table XVIII: Current rebates

Description	Amount
Primary rebate	R10 260
Secondary rebate	R5 675

Table XIX: Proposed rebates

Description	Reference to Income Tax Act, 1962	Amount
Primary rebate	Section 6(2)(a)	R10 755
Secondary rebate	Section 6(2)(b)	R6 012
Tertiary rebate	Section 6(2)(c)	R2 000

Table XX: General savings thresholds

Description	Reference to Income Tax	Monetary amount

(The contents of this column are solely for convenience and shall be of no force or effect)	Act, 1962	
Broad-based employee share schemes		
Maximum exemption for shares received by an employee in terms of a broad-based employee share plan	Definition of “qualifying equity share” in section 8B(3)	R50 000
Maximum deduction for shares issued by an employer in terms of a broad-based employee share plan	The proviso to section 11(IA)	R10 000
Exemption for interest and certain dividends		
Exemption for foreign dividends and interest from a source outside the Republic which are not otherwise exempt	Section 10(1)(i)(xv)(aa)	R3 700
In respect of persons 65 years or older, exemption for interest from a source within the Republic and dividends (other than foreign dividends) which are not otherwise exempt	Section 10(1)(i)(xv)(bb)(A)	R33 000
In respect of persons younger than 65 years, exemption for interest from a source within the Republic and dividends (other than foreign dividends) which are not otherwise exempt	Section 10(1)(i)(xv)(bb)(B)	R22 800
Annual donations tax exemption		
Exemption for donations made by entities	Section 56(2)(a) and the proviso thereto	R10 000
Exemption for donations made by individuals	Section 56(2)(b)	R100 000
Capital gains exclusions		
Annual exclusion for individuals and special trusts	Paragraph 5(1) of Eighth Schedule	R20 000
Exclusion on death	Paragraph 5(2) of Eighth Schedule	R200 000
Exclusion in respect of disposal of primary residence (based on	Paragraph 45(1)(a) of	R1,5 million

amount of capital gain or loss on disposal)	Eighth Schedule	
Exclusion in respect of disposal of primary residence (based on amount of proceeds on disposal)	Paragraph 45(1)(b) of Eighth Schedule	R2 million
Maximum market value of all assets allowed within definition of small business on disposal when person over 55	Definition of "small business" in paragraph 57(1) of Eighth Schedule	R5 million
Exclusion amount on disposal of small business when person over 55	Paragraph 57(3) of Eighth Schedule	R900 000

Table XXI: Retirement savings thresholds

Description (The contents of this column are solely for convenience and shall be of no force or effect)	Reference to Income Tax Act, 1962	Monetary amount
Deductible retirement fund contributions		
Pension fund monetary ceiling for contributions	Proviso to section 11(k)(i)	R1 750
Pension fund monetary ceiling for arrear contributions	Paragraph (aa) of proviso to section 11(k)(ii)	R1 800
Retirement annuity fund monetary ceiling for contributions (if also a member of a pension fund)	Section 11(n)(aa)(B)	R3 500
Retirement annuity fund monetary ceiling for contributions (if not a member of a pension fund)	Section 11(n)(aa)(C)	R1 750
Retirement annuity fund monetary ceiling for arrear contributions	Section 11(n)(bb)	R1 800
Permissible lump sum withdrawals upon retirement		
Pension fund monetary amount for permissible lump sum withdrawals	Paragraph (ii)(dd) of proviso to paragraph (c) of definition of "pension fund" in section 1	R50 000
Retirement annuity fund monetary amount for permissible lump sum withdrawals	Paragraph (b)(ii) of proviso to definition of "retirement annuity fund" in section 1	R50 000

Table XXII: Deductible business expenses for individuals

Description (The contents of this column are solely for convenience and shall be of no force or effect)	Reference to Income Tax Act, 1962	Monetary amounts
Car allowance		
Ceiling on vehicle cost	Section 8(1)(b)(iiiA)(bb)(A)	R480 000
Ceiling on debt relating to vehicle cost	Section 8(1)(b)(iiiA)(bb)(B)	R480 000

Table XXIII: Employment-related fringe benefits

Description (The contents of this column are solely for convenience and shall be of no force or effect)	Reference to Income Tax Act, 1962	Monetary amounts
Exempt scholarships and bursaries		
Annual ceiling for employees	Paragraph (ii)(aa) of proviso to section 10(1)(q)	R100 000
Annual ceiling for employee relatives	Paragraph (ii)(bb) of proviso to section 10(1)(q)	R10 000
Exempt termination benefits	Section 10(1)(x)	R30 000
Medical scheme contributions		R720
Monthly ceiling for schemes with one beneficiary	Section 18(2)(c)(i)(aa) and paragraph 12A(1)(a) of Seventh Schedule	R670
Monthly ceiling for schemes with two beneficiaries	Section 18(2)(c)(i)(bb) and paragraph 12A(1)(b) of Seventh Schedule	R1 440
Additional monthly ceiling for each additional beneficiary	Section 18(2)(c)(i)(cc) and paragraph 12A(1)(c) of Seventh Schedule	R440
Awards for bravery and long service	Paragraphs (a) and (b) of further proviso to paragraph 5(2) of Seventh Schedule	R5 000

Employee accommodation	Paragraph 9(3)(a)(ii) of Seventh Schedule	R59 750
Accommodation for expatriate employees	Paragraph 9(7B)(ii) of Seventh Schedule	R25 000
Exemption for de minimis employee loans	Paragraph 11(4)(a) of Seventh Schedule	R3 000
Additional employer deductions for learnerships		
Monetary ceiling of additional deduction for the employer when utilising a learnership agreement with an employee	Section 12H(2)	R30 000
Monetary ceiling of additional deduction for the employer in the case of an employee completing a learnership agreement	Section 12H(3) and (4)	R30 000
Monetary ceiling of additional deduction for the employer involving a learnership agreement with an employee with a disability	Section 12H(5)	R20 000

Table XXIV: Depreciation

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

Table XXV: Miscellaneous

Description (The contents of this column are solely for convenience and shall be of no force or effect)	Reference to Income Tax Act, 1962	Monetary amounts
Low-cost housing		
Maximum cost of residential unit where that residential unit is an apartment in a building	Paragraph (a) of definition of “low-cost residential unit” in section 1	R250 000

Maximum cost of residential unit where that residential unit is a building	Paragraph (b) of definition of "low-cost residential unit" in section 1	R200 000
Industrial policy projects		
Maximum additional investment allowance in the case of greenfield projects with preferred status	Section 12I(3)(a)	R900 million
Maximum additional investment allowance in the case of other greenfield projects	Section 12I(3)(a)	R550 million
Maximum additional investment allowance in the case of brownfield projects with preferred status	Section 12I(3)(b)	R550 million
Maximum additional investment allowance in the case of other brownfield projects	Section 12I(3)(b)	R350 million
Maximum additional training allowance (per employee)	Section 12I(5)(a)	R36 000
Maximum additional training allowance in the case of industrial policy projects with preferred status	Section 12I(5)(b)(i)	R30 million
Maximum additional training allowance in the case of other industrial policy projects	Section 12I(5)(b)(ii)	R20 million
Minimum cost of manufacturing assets for greenfield projects	Section 12I(7)(a)(i)(aa)	R200 million
Amounts to be taken into account in determining whether an industrial project constitutes a brownfield project	Section 12I(7)(a)(i)(bb)(A) Section 12I(7)(a)(i)(bb)(B)	R30 million R200 million
Venture capital companies		
After 36 months, at least 80 per cent of the expenditure incurred by a venture capital company must be incurred in respect of qualifying shares in a junior mining company, with assets of which the book value does not exceed the amount indicated immediately after the issue	Section 12J(6A)(b)(i)	R300 million
After 36 months, at least 80 per	Section 12J(6A)(b)(ii)	R20 million

cent of the expenditure incurred by a venture capital company must be incurred in respect of qualifying shares in a company, other than a junior mining company, with assets of which the book value does not exceed the amount indicated		
Presumptive turnover tax		
A person qualifies as a micro business for a year of assessment where the qualifying turnover of that person for that year does not exceed the amount indicated	Paragraph 2(1) of Sixth Schedule	R1 million
Maximum of total receipts from disposal of immovable property and assets of a capital nature by micro business	Paragraph 3(e) of Sixth Schedule	R1,5 million
Minimum value of individual assets and liabilities in respect of which a micro business is required to retain records	Paragraphs 14(c) and (d) of Sixth Schedule	R10 000
Public benefit organisations		
PBO trading income exemption	Section 10(1)(cN)(ii)(dd)(ii)	R200 000
Deduction of donations to transfrontier parks	Section 18A(1C)(a)(ii)	R1 million
Housing provided by a PBO: maximum monthly income of beneficiary household	Paragraph 3(a) of Part I of Ninth Schedule and paragraph 5(a) of Part II of Ninth Schedule	R7 500
Recreational clubs		
Club trading income exemption	Section 10(1)(cO)(iv)(bb)	R120 000
Prepaid expenses		
Maximum amount of deferral	Paragraph (bb) of proviso to section 23H(1)	R80 000
Small business corporations		
Maximum gross income	Section 12E(4)(a)(i)	R14 million
Housing associations		
Investment income exemption	Section 10(1)(e)	R50 000

Table XXVI: Administration (Taxation Laws Second Amendment Bill)

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

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

Description (The contents of this column are solely for convenience and are of no force or effect)	Reference to Value-Added Tax Act, 1991	Monetary amount
Registration		
-Compulsory	Section 23(1)(a)	R1 million
-Voluntary	Section 23(3)(b), (c) and (d)	R50 000
-Commercial accommodation	Paragraph (a) of definition of ‘commercial accommodation’ in section 1	R60 000
-Payments basis of VAT registration	Section 15(2)(b)(i)	R2,5 million
-Exception to payments basis : in respect of supplies of goods or services made by a vendor	Section 15(2A)	R100 000
Tax invoices		

-Abridged tax invoice	Section 20(5)	R3 000
-No tax invoice required	Section 20(6)	R50
Tax periods		
- Category C (monthly) submission of VAT 201 return	Section 27(3)(a)(i)	R30 million
-Category D (6-monthly) submission of VAT 201 return	Section 27(4)(c)(i)	R1,5 million
-Category F (4-monthly) submission of VAT 201 return	Section 27(4B)(a)(i)	R1,5 million

Table XXVIII: Transfer Duty: Imposition

Value	Rate of Tax
Does not exceed R600 000	0%
Exceeding R600 000 but not exceeding R1 million	3% on such value
Between R1.0 million and R1.5 million	5% of such value plus R12 000
Exceeds R1.5 million	8% on such value plus R37 000

Table XXIX: Diamond Export Levy: Rate and Exemptions

Exemption from levy (Levy not applicable in following instances)	Applicable levy
	5% of gross sales
Large producers	
-40% of the producer’s gross sales must be to South African diamond beneficiators, and	
-total gross sales must exceed R3 billion	
Medium producers	
-15% of the producer’s gross sales must be to South African diamond beneficiators, and	
-total gross sales exceeds R20 million but does not exceed R3 billion	
Small producers	

-total gross sales does not exceed R20 million	

Table XXX: Royalty Act: Rate and Exemption

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

Table XXXI: Estate Duty: Rates, thresholds and abatement

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

2. INCOME TAX: EMPLOYMENT, INDIVIDUALS AND SAVINGS

2.1 RETIREMENT: THIRD REBATE FOR THE ELDERLY

[Key provision: Section 6]

I. Background

The tax system contains two rebates applicable to natural persons – a primary rebate and a secondary rebate. The primary rebate is available to all natural persons; whereas, the secondary rebate is available solely to persons of age 65 or more.

II. Reasons for change

The purpose of the rebates is to provide relief for subsistence level living. The secondary rebate recognises that subsistence living may be higher at old age due to ill-health and loss of job opportunities. The net effect of this rebate is to shelter passive income, regardless of source (e.g. annuities and interest).

At issue is the depth of the relief. Many elderly persons, especially those of more advanced age, are under pressure with risk-free yields dropping nationally as well as globally. This decline on risk-free yields has a unique impact on the elderly who are seeking stable income in their final years. Given this impact, many elderly persons are seeking some form of tax relief to maintain sufficient funding without direct subsidies from Government.

III. Proposal

In order to provide further relief for persons of advanced age, a third rebate is proposed. Persons of age 75 or more will now be entitled to a third rebate (in addition to the previous two rebates). This third rebate will equal R2 000.

IV. Effective date

The proposed amendment will be effective from 1 March 2011.

2.2 RETIREMENT: LIVING ANNUITY CONVERSION TO DRAWDOWN ACCOUNTS

[Key provision: Section 1 (definition of "retirement income drawdown account")

I. Background

At retirement, individuals have certain options available regarding permissible withdrawals of contractual retirement savings. In the case of pension funds and individual retirement annuities, up to one-third of available savings may be withdrawn as a lump sum while the two-thirds balance must be paid out via an annuity.

Compulsory retirement annuities can take the form of guaranteed annuities or living annuities.

Guaranteed annuities generally provide benefits until the death of the recipient and/or the spouse. Living annuities operate more like a savings account with benefits solely based on fund accumulations.
In particular, living annuities must have the following characteristics:
The total value of the annuity must be linked to the value of the assets or retirement savings used to purchase the annuity;
The drawdown level chosen by the recipient must be set between 2.5 per cent and 17.5 per cent;
Once the total value of the assets or savings falls to a level of R75 000 or less, the total amount may be withdrawn as a lump sum;
The amount of the annuity cannot be guaranteed by the provider; and
When the recipient dies, the remaining savings may be withdrawn by his/her nominee as a lump sum or continued as an annuity.
As a practical matter, guaranteed annuities and living annuities are very different products. In the case of a guaranteed annuity, the risk of longevity falls on the product provider. In the case of living annuities, the risk of performance rests solely with the recipient (thereby requiring close and constant monitoring by the recipient to ensure performance). Guaranteed annuities can only be offered by providers registered under the Long-term Insurance Act, and living annuities currently operate under the same registration restriction.

II. Reasons for change

Competition in the market generally leads to improved product choice and reduced fees. Criticism has been laid against living annuities due to their high costs (especially upon initial conversion from retirement savings). Because living annuities can seemingly be offered only by insurers (outside of retirement funds), it is contended that many problems associated with these products can be solved through increased competition beyond a narrow group of insurance providers.

On a technical level, living annuities (as defined in the Income Tax Act) are not true annuities. The drawdown levels can be altered annually so the payment is not permanently fixed into a narrow framework. More importantly, living annuities do not really operate as insurance products because the risk does not pass to the insurer but remains solely with the recipient retiree. Payments for life are not guaranteed and once the capital savings are depleted, the annuity ends.

The view is that therefore that it will be appropriate, and in the interest of the public that the service providers in respect of living annuities be extended to entities other than only retirement funds and insurers. One of the effects of opening up the market on living annuities to other providers is that there will be an increase in the migration of living annuities from differed providers to other low-cost providers. It is also a fact that recipients who derive living annuity income from more than one source or a fragmented income from the same source often require their annuities to be combined into one living annuity contract.

This combining of living annuities is to be encouraged since it is not only cost effective, but there is a lesser likelihood of the capital value of the assets falling below R50 000, resulting in a commutation. Therefore, the necessary amendments must be made to facilitate changes to the frequency of the payment and the drawdown percentage levels, as a result of the combining of living annuities. This opportunity will also be used to make practical amendments that will address specific issues that have been raised by the industry.

III. Proposal

The requirements associated with living annuity products will be realigned to conform with their true nature. Firstly, the product will be renamed as a "retirement income draw down account" (RIDDA) with the "annuity" concept wholly removed. Via regulation, law will allow these revised products to be offered by insurers, retirement funds and other specified entities. The minimum 2.5 per cent draw down level will also be removed (because a minimum draw down is more consistent with an annuity product).

As a result of this proposed changes, the proposed drawdown account must satisfy the following criteria:

The total value of the annuity must be linked to the value of the assets or retirement savings used to purchase the annuity;

The amount of the annuity cannot be guaranteed by the provider;

No more than 17.5 per cent of the remaining balance can be withdrawn in any one year (except as contemplated in the next bullet below);

Once the total value of the assets or savings falls to a level of R75 000/R50 000 or less, the total amount may be withdrawn as a lump sum;

When the recipient dies, the remaining savings may be withdrawn by his/her nominee as a lump sum or continued as an annuity.

The following two changes were also added for clarification:
The current legislation in respect of the death of a recipient seemingly states that the value of the assets may be paid to a nominee either as an annuity or as a lump sum. No good reason exists in principle to deny a combination of both. The law will be clarified accordingly.

There is no clear statement in the legislation on whether a compulsory annuity can be continued by person other than a natural person. However, due the nature of living annuities as compulsory retirement savings, it is the policy view that it cannot be held by any person other than a natural person. This view is reflected in the legislation which makes the retirement tax table available to the commutation of living annuities.
The current regulations that have been issued in terms of the definition of "living annuity" will as far as possible be incorporated into the new definition.

IV. Effective date

The proposed amendment will be effective for agreements in effect on or after 1 March 2012.

2.3 LONG - TERM INSURANCE: CONTRIBUTIONS AS A FRINGE BENEFIT

[Key provisions: paragraph 12B of the Seventh Schedule]

I. Background

Employers provide for employee death or permanent disability cover largely through one of two mechanisms. Employers can provide this cover through 'approved' plans (i.e. group long-term insurance with pension or provident funds being the policyholder) or through unapproved plans. An 'unapproved' group life or disability policy is taken out by employers for the benefit of these employees (or their dependants). These policies can qualify as a pure risk or investment policy, or a combination of both. Each of these policies makes payment upon the happening of a "life" or "disability" event.

Unapproved plan premiums are paid by employers because the employer is the policyholder. However, the party to whom the payment is made may vary. The policy can be structured so that the proceeds can be paid directly to the employees (or their beneficiaries) or to the employer. If the payout is made to the employer, a side arrangement usually exists so that the employer is obligated to turn over the insurance proceeds (or their equivalent) to the employees (or their beneficiaries).

II. Reasons for change

If an employer enters into a group life/disability plan for the direct or indirect benefit of the employees (or their beneficiaries), the employer can only deduct the insurance premiums if these premiums give rise to a simultaneous fringe benefit inclusion for the employees. Unapproved group life plans with employees (or their dependants) as named beneficiaries clearly give rise to taxation as a fringe benefit. This matching principle has a similar effect as the non-deductible payment of premiums by persons seeking cover.

Alternatively, if an employer is the named beneficiary but has a side arrangement with the employee (or a mere intention or practice to pay over the policy proceeds to that employee), the tax impact should be the same. The employer is effectively incurring the expense of a "service" for the benefit of the employee. Nonetheless, the lack of explicit language has given rise to unnecessary disputes with some taxpayers taking the position that many of these indirect arrangements are beyond the reach of the fringe benefit regime.

III. Proposal

Long-term insurance as a fringe benefit
In view of the above, explicit fringe benefit rules will be added for employer-provided long-term insurance. More specifically, employer premiums or similar payments made to group long-term insurance will be treated as a fringe benefit if the insurance is for the direct or indirect benefit of employees (or their dependants/nominees). Fringe benefit inclusions for these benefits will equal employer premium contributions (i.e. will be deemed to be the value of the taxable fringe benefit).

Special rules for disability
Employer-provided disability policies will largely follow the same paradigm as unapproved group plans that protect against death. However, a long-held distinction exists between two forms of disability plans – income capacity versus income protection. Income capacity plans operate just like life plans (deductible employer premiums matched by employee fringe benefit inclusions). On the other hand, in the case of an income protection policy, the individual is incurring an expense related to the production of income with the premium being deductible by the individual (and with the payment of proceeds resulting in gross income – see drafter note on policy payouts).

While premiums paid by individuals for disability income protection plans are deductible if paid by those individuals for their own coverage, recent revisions to the rules for employer-provided insurance have raised questions about the impact of those rules in respect of employer-provided income protection plans. In particular, these plans seem to give rise to employer-premium deductions and employee fringe benefit inclusions. However, employees seemed to have lost the option of the deducting the premiums paid on their behalf. This option will be restored.

IV. Effective date

These amendments will apply to all premiums incurred during any year of assessment commencing on or after 1 January 2011.

2.4 LONG-TERM INSURANCE: KEY PERSON PLAN ELECTIONS

[Key provision: Section 11(w)(ii)]

I. Background

Commercial rationale
Some businesses take out keyman insurance policies on the life of an employee or director (the key person) whose services contribute substantially to the success of the business.
The policy is owned and paid by the business (i.e. the business is the policyholder for protection against the loss of profits associated with the loss of a key person). The proceeds may assist in:
Keeping the business running (e.g. covering merchandise and other expenses);

Surviving losses during the adjustment period (i.e. loss of clients due to the loss of the key person);
Meeting the special expenses of recruiting and training a new employee;
Ensuring continuance of credit facilities by significant credit providers; and/or guaranteeing the continuance of dividends and salaries.
These expenses are potentially deductible by the employing business. However, it should be noted that no deduction is available in the case of premiums incurred in respect of a long-term insurance policy taken out with the intention to repay a loan, repurchase shares, or buy out a partner. In these cases, no loss is being guarded against and the expenses are not incurred in the production of the income – but instead to repay capital.

Recently revised tax criteria
The tax impact of key person plans depends on whether the plan is conforming or non-conforming. Employers with conforming plans (i.e. those meeting certain statutory requirements) can deduct the premiums in respect of those plans; whereas, no deduction is allowed for non-conforming plans. Insurance pay-outs from conforming plans give rise to tax; pay-outs from non-conforming plans are generally viewed as tax-free.

In 2010, the distinction between conforming and non-conforming key person insurance policies that provide cover against the loss key persons was fundamentally revised. Under the revised rules (taking effect from 1 January 2011), a conforming plan contains four criteria:

The business must be insured against the loss of a key person by reason of death, disability or severe illness;
The policy must solely be a risk policy (without any cash or surrender value associated with investment policies);
The taxpayer must be the sole owner of the policy (setting aside the holding of technical title by creditors as collateral security); and
No transaction, operation or scheme may exist for the business to turn over policy proceeds (or their equivalent) to those key persons (or their beneficiaries).

II. Reasons for change

The rules relating to key person plans were changed based on the assumption that employers entering into genuine key person plans desired an upfront deduction. This assumption, however, turned out to be misguided. To the extent that long-term insurance is genuinely used to protect against lost profits due to the loss of key persons, employers largely seek to obtain tax-free insurance proceeds at the expense of an upfront deduction. The tax-free nature of the proceeds is viewed as the top priority. Otherwise, employers must top-up these plans to additionally cover potential taxes to be paid.

Employers seeking false-key person plans, on the other hand, were the main drivers for the upfront deduction. The goal for this category of employers was an upfront deduction for the employer without a corresponding fringe benefit in respect of the premiums for the employee. The taxable nature of the payment proceeds was ultimately less of a concern for employers because these payment proceeds were largely intended for the benefit of the employees (or their beneficiaries).

III. Proposal

Plans entered into from 1 January 2012
In view of the above, taxpayers seeking an upfront deduction for key person policy plans will now have to opt into the regime (conforming treatment). Inaction will mean that the policy will remain non-conforming (despite satisfying the other objective requirements). Non-conforming treatment means that the policy will give rise to an exempt payment of proceeds at the expense of a non-deductible contribution. It is assumed that most employers will opt for inaction to obtain non-conforming treatment.

Taxpayers seeking to opt into the regime must express a choice in the policy agreement by stating that section 11(w)(ii) is intended to apply to that policy agreement. This choice is to be expressed by making this statement in the policy agreement so that the choice is clearly visible for all parties involved (including SARS). The one-off choice cannot be changed once made.

Pre-existing plans
Taxpayers with pre-existing key person plans have slightly different objectives. Their goal is mainly to preserve their prior position. Therefore, if a taxpayer has a policy entered into before 1 January 2012 that satisfies the post-effective date objective criteria for conforming plans, the taxpayer may similarly opt into the regime as above (even though the intention was not initially expressed at the beginning). In this scenario, the taxpayer expresses this choice by adding an addendum to the policy agreement. This addendum will states that section 11(w)(ii) is intended to apply to that policy agreement. Again, the one-off choice expressed cannot be changed once made. In addition, this choice must be expressed by 30 June 2012. Taxpayers with pre-existing key person plans without the addendum will be viewed as having non-conforming plans.

IV. Effective dates

The proposed amendment is effective retrospectively in respect of premiums incurred from 1 January 2011. In respect of policies in existence before 1 January 2012, the policyholder must express the choice in favour of a section 11(w)(ii) deduction within the policy agreement (by way of addendum) by the close of 1 June 2013. This choice is effective from 1 January 2011.

2.5 LONG-TERM INSURANCE: TAXATION OF PROCEEDS

[Key provisions: Paragraph (m) of the definition of “gross income” in Section 1; section 10(1)(gG); section 10(1)(gH); paragraph 55 of the Eighth Schedule]

I. Background

Types of long-term insurance policies
Long-term insurance essentially comes in two major forms:

A facility to provide risk cover in the form of life, disability, accident, and dread disease; and/or

An investment function providing the holder with investment access into a portfolio of assets (which the insurer may or may not partially guarantee).

Therefore, a long-term policy can be either risk-based or investment- based (or a combination of both).

In the basic paradigm, individuals acquire their own insurance for the benefit of themselves or their designated beneficiaries. Other circumstances in which insurance may be required include the following:

Employers may acquire insurance on behalf of their employees (or the designated beneficiaries of their employees).

Employers may acquire insurance to cover the business against the potential loss of profits due to the unexpected loss of key persons.

An entity (or the owner thereof) may acquire insurance in order to buy out ownership in the case one of the owners dies.

Impact of policy proceeds

The tax treatment associated with policy proceeds received in respect of long-term insurance policies (risk and/or investment) is governed by a combination of common law, legislation and practice. Basic common law appears to view lump sum proceeds as capital in nature (thereby falling outside of ordinary revenue). Special legislative rules exist for key person policy plans and for income protection policies.

An explicit set of capital gain rules exist for long-term insurance proceeds. Original holders and beneficiaries are often free from capital gains taxation with secondary holders being subject to capital gains tax. This capital gains tax treatment for secondary holders was designed to eliminate the secondary market in respect of endowment plans. The capital gains tax also contains a few additional exemptions with long-term insurance policy proceeds conceivably becoming subject to capital gains tax if the proceeds arise in circumstances that fall between the exemption gaps.

II. Reason for change

In order to create certainty in the industry, it is necessary to clarify the ordinary revenue and capital gains tax treatment of proceeds derived from long-term insurance policies. The law in this area is essentially ad hoc, lacking any unifying theoretical theme and fails to properly integrate the ordinary revenue and capital gains tax systems. Lastly, much of the law has failed to properly reflect the overall existence of risk versus investment policies dominating the industry.

III. Proposal

Overview

In view of the above, a comprehensive set of rules are proposed to cover the tax treatment of long-term insurance policies. As a general matter, proceeds received or accrued from insurers in respect of long-term insurance policies will initially be treated as ordinary revenue (subject to significant exemptions). Application of these rules will essentially fall into the following paradigm:

- If premiums were funded with post-tax contributions, policy proceeds will be tax-free; or

- If the premiums were funded with pre-tax contributions, policy proceeds will be taxable.

The capital gains tax will act as a residual regime. This residual regime will mainly impact second-hand owners of long-term insurance policies.

Taxable versus exempt ordinary revenue

Initial inclusion as gross income

It is proposed that all amounts directly or indirectly received or accrued from an insurer in terms of a long-term insurance policy (risk and/or investment) will initially be included as gross income. This inclusion will typically cover proceeds payable upon the contingency of death, disability, etc… The policy may or may not be surrendered as a result. Moreover, loans or advances granted by an insurer based on the value of the policy will similarly be included in gross income. However, when policy proceeds are eventually paid, gross income must be reduced by the inclusion triggered by the loan or advance previously granted (to prevent a double inclusion).

As a side matter, this regime does not apply if the proceeds of a policy stem from group life plans associated with pension or provident fund membership. These plans are excluded because proceeds in these circumstances are taxed under the retirement tax regime (i.e. pursuant to the lump sum formula).

Exemptions from gross income

Gross income falls under one of two overall exemptions – an exemption for policyholders receiving proceeds and an alternative exemption for non-policyholder beneficiaries receiving proceeds. As stated above, application of these exemptions depends on whether the policies are funded with post-tax or pre-tax contributions.

If the policyholder receives the insurance proceeds, these proceeds will be tax-exempt unless one or more premiums were deductible by the policyholder. If one or more premiums were deductible, a tax exemption may still exist, but the exemption is limited solely to the amount of the non-deductible premiums contributed.

If a beneficiary other than the policyholder receives the proceeds (either from the insurer or the policyholder), the distinction between taxable and tax-free proceeds is based on the same concepts but is slightly more complex. More specifically:

- Insurance proceeds received by a non-policyholder beneficiary will be tax-exempt only if all the premiums “did not rank” for a deduction by the policyholder. For instance, if a municipality enters into an unapproved group life plan on behalf of the municipality’s employees, the premiums will rank for a deduction (even though the municipality is an exempt entity).

- However, the above rule is subject to a key exception. Under this exception, even if the premium contributed ranked for deduction, policy proceeds will be fully exempt as long as these pre-tax contributions are matched by a corresponding taxable inclusion for the beneficiary (typically as an employee fringe benefit).

(Note: In the case of pure risk policies, this aspect of the rule contains transitional relief with premiums only being measured from 1 January 2011.) However, this exception will not apply if the matched taxable premiums are further matched by deductions in the hands of the beneficiary.

- It should be noted that if tainted contributions are made (e.g. deductible without a corresponding fringe benefit or with a corresponding fringe benefit deductible by the beneficiary), the policy proceeds are fully taxable with a limited exemption. Under this limited exemption, exempt policy proceeds are limited solely to the amount of the non-tainted premiums contributed.

Practical examples

An individual policyholder cannot claim a deduction in respect of premiums paid on a life insurance policy. Therefore, the proceeds from these life policies will be tax-exempt.
In the case of an individual income protection policy, the premiums paid by the individual are typically deductible. Therefore, the proceeds will be taxable.
An employer will receive a deduction for premiums contributed in respect of an unapproved group life policy. However, the employee will be deemed to receive matching fringe benefit income in respect of the premiums. Therefore, the proceeds will be tax-exempt.
In the case of an employer group income protection policy, the employer deducts the premiums and the employee initially has matching fringe benefit income. However, the employee will obtain a simultaneous deduction for the premiums (thereby neutralising the tax as a fringe benefit). As a result, the policy proceeds will be taxable when paid to the employee.
The impact of policy proceeds in respect of key person plans is largely open-ended. The employer decides upfront whether the premiums will rank for a deduction in the case of a key person policy (refer to the drafter note on Employer Long-Term Insurance Coverage to Protect against the Loss of Key Persons). The proceeds will be taxable if the employer chooses in favour of a deduction or exempt if the employer chooses otherwise.
Capital gains tax
As under current legislation, second-hand long-term insurance policies will remain subject to capital gains tax. The intention is to continue to discourage the trade in second-hand policies (that is, policies purchased from or ceded to another person by the original beneficial owner).

It is now proposed that all risk policies be additionally excluded from the application of capital gains tax (including second-hand policies). The nature of a risk policy prohibits these policies from being regularly traded as a ‘second-hand’ policy because these policies do not have inherent tradable value.

In the main, the other currently exiting exclusions will remain within the capital gains regime for long-term insurance. In this light, it should be noted that the exemption in respect of section 11(w) policies will remain, thereby covering pre-2011 and post-2011 policies.

IV. Effective date

The proposed amendments are effective for amounts received or accrued in respect of years of assessment commencing on or after 1 January 2012.

2.6 MEDICAL SCHEME CREDITS

[Key provisions: Section 6A; Section 18(2)(c)]

I. Background

Even though the income tax system does not generally allow for deductions in respect of personal consumption, medical expenses remain a notable deviation. An incentive exists for taxpayers to make contributions to medical schemes. Taxpayers making these contributions receive a set level of monthly deductions depending on the number of persons utilising the scheme. These deductions are premised on contributions associated with average minimum benefits associated with all domestic medical schemes. Over the years, the level of permissible deductions for these contributions has been adjusted upward on an annual basis.

II. Reasons for change

Several years ago, deductions for medical scheme contributions were switched from a $2/3^{rds}$ approach to a set formula because the $2/3^{rds}$ formula awarded taxpayers with more expensive plans. This $2/3^{rds}$ rule was viewed as providing unfair benefits for upper-income families that could afford more expensive plans. The revised system of set monthly numerical deductions was designed to level the playing field.
Currently at issue is the use of deductions. It is now contended that the current deduction system still operates to the unfair benefit of wealthier taxpayers. The net effect of a deduction in respect of low-taxed workers is an effective savings of 18 per cent of the contributions; whereas, wealthier individuals achieve an effective savings of 40 per cent.

III. Proposal

Annual adjustment for 2011
In terms of 2011, deductions for monthly medical contributions will again be raised. Taxpayer contributions are set at R720 for the benefit of the taxpayer and at R720 for the benefit of the taxpayer's spouse. Deductible contributions for coverage relating to other dependents are set at R440 per dependant.

Conversion to a credit system

In the longer term, it is proposed that the deduction system for medical contributions be converted into a credit system. Under the credit system, all taxpayers will receive a tax credit for monthly medical contributions that will equally benefit all taxpayers in nominal terms. In particular, taxpayers will receive a monthly tax credit of R216 per month for themselves and their spouses. In terms of other dependants, these credits will be set at

R144 per person. A supplementary credit will exist for the elderly (those from age 65) and for the disabled.

Pending discussion document

A discussion document is pending that further clarifies the policy associated with the conversion from deductions to credits in respect of medical scheme contributions. The discussion document also investigates the use of a tax credit system in respect of out of pocket medical expenses.

IV. Effective date

The increased annual deductions associated with medical scheme contributions will be effective for all contributions occurring on or after 1 March 2011. The credit system for medical scheme contributions will be effective from 1 March 2012.

2.7 DIVIDENDS FROM EMPLOYEE SHARE BASED SCHEMES

[Key provision: Section 10(1)(k)(i)(dd)]

I. Background

A. Disposal or vesting of restricted share incentive schemes

Anti-avoidance rules exist to prevent taxpayers from disguising high-taxed salary through the use of restricted share (or share-based) incentive schemes that would otherwise trigger low-taxed (or even no-taxed) income or capital gains. These anti-avoidance rules essentially trigger ordinary revenue when these instruments are disposed of by employees (or fully vest for their benefit). The triggering events are designed to be delayed so that the appreciation associated with these schemes is fully taxed.

The anti-avoidance rules at issue technically apply to "restricted equity instruments." The term equity instrument" is fairly expansive, including shares and share-based rights associated with shares. These share-based rights even include contractual rights or obligations, the value of which is determined directly or indirectly with reference to a share. In order for an equity instrument to be viewed as a restricted equity instrument, these equity instruments must contain one or more restrictions that mainly relate to the disposal or ownership of those instruments.

B. Dividends from share incentive schemes

In 2010, further amendments were added to prevent avoidance schemes stemming from the dividend aspect of restricted share (or share-based) incentive schemes. More specifically, dividends in respect of equity instruments will be treated as ordinary revenue unless the instruments constitute an equity share or the dividend itself constitutes an equity instrument. The purpose of these dividend rules is to prevent taxpayers from converting high-taxed salary into low (or no) taxed dividends. The schemes of concern relate to shares whose sole value relates to dividend rights held by employees.

II. Reasons for change

The newly added anti-avoidance rule of 2010 appears to be an effective regime for preventing the use of dividends from restricted shares (or share-based) incentive schemes as a mechanism to disguise salary. However, the new rule is seemingly overly broad, covering transactions never intended. Of particular concern is the holding of shares through employee trusts.
While employee trusts are a common source of mischief, many employee trusts exist simply as a matter of administrative convenience in order to simplify administration of widely used employee shares. Some of these trusts contain restrictions so that the employees retain some interest in the employer for a meaningful duration. This form of restriction is common in the case of black economic empowerment. The net result is to impose ordinary revenue treatment in respect of dividends arising from almost all employee share trusts.

III. Proposal

The proposed legislation retains ordinary treatment for restricted equity share schemes as a general rule, but the revised legislation contains a carve-back. The purpose of the carve-back is to limit the new anti-avoidance rule without re-opening pre-existing avoidance. More specifically, dividends in respect of (otherwise unrestricted) equity shares held in trusts will be excluded from the anti-avoidance rule if permitted by Ministerial regulation.

IV. Effective date

The proposed amendment will be effective as of 1 January 2011 in respect of dividends received or accrued on or after that date.

2.8 ROAD ACCIDENT FUND PAYOUTS

[Key provision: Section 10(1)(gB)]

I. Background

Road Accident Fund compensation
The Road Accident Fund is designed to operate as a national centralised financial pool that provides compensation for damages sustained in motor vehicle accidents (Road Accident Fund Act, 1956 (Act No. 56 of 1996)). Compensation relates to bodily injury and death (including associated direct and indirect costs).

Taxation of lump sums versus annual payments
The starting point for determining gross income is to include all receipts and accruals other than amounts of a capital nature. In terms of court-related claims, lump sum payments would generally qualify as capital amounts so as to be exempt. On the other hand, annualised payments would fall squarely within gross income. Upfront amounts typically replace permanent capital lost; whereas, annualised amounts typically act as a substitute for lost anticipated gross income.

II. Reason for change

Compensation paid by the Road Accident Fund is currently paid in the form of a lump sum. The Road Accident Fund is now planning to additionally allow for claims to be paid in the form annualised amounts spread over several years. The annualised spreading of income often operates as a better method of providing financial security for victims seeking to recover from (or merely survive) serious vehicle accidents. Annualised payments effectively spare the victims from having to undergo the risk of managing lump sums so as to cover victims and their families over extended periods of hardship.

III. Proposal

While the capital versus ordinary distinction in the case of involuntary compensation is not being questioned, special relief currently exists for various forms of Government payments. This relief for Government payments applies regardless of whether amounts are paid as an annuity or as a lump sum. For instance, workmen's compensation paid pursuant to the Compensation for Occupational Injuries and Diseases Act, 1993 (Act No. 130 of 1993) is fully exempt. This exemption applies regardless of whether the amounts paid are in the form of a lump sum or as annualised payments. In essence, workmen's compensation never fully makes the taxpayer whole from work-related injury, thereby justifying special tax relief.

It is accordingly proposed that payments pursuant to claims against the Road Accident Fund be treated in the same fashion as workmen's compensation. Payments in respect of claims from the Road Accident Fund should be fully exempt regardless of whether the payment is in the form of an upfront lump sum or in the form of annualised payments.

IV Effective date

The proposed amendment is effective for Road Accident Fund payments received or accrued on or after 1 March 2012.

2.9 EMPLOYEE COMPENSATION FUND ENTITIES

[Key provisions: Sections 10(1)(d); section 10(1)(T)(xvi) proviso (xi) to section 1 of the "enterprise" definition of VAT]

I. Background

Regulatory overview
The Compensation for Occupational Injuries and Diseases Act (COIDA) regulates the compensation relating to the death or personal injury suffered by an employee in the course of employment. The central role-player in respect of COIDA is the Compensation Fund, an entity wholly owned by Government and operated under the supervision of the Compensation Commissioner. Employer contributions to the Compensation Fund are comprised of assessment contributions determined in terms of

the Standard Assessment Rate announced in the Government Gazette as set by the Compensation Commissioner. The rates imposed on an employer are based on death/injury risk ratios within the industry in question. The Compensation Commissioner also sets the injury/death benefit payouts to employees (or their dependents).

COIDA also allows for the license of private mutual entities to operate comparable injury/death benefit schemes in lieu of the Compensation Fund (section 30 of the COIDA). Minimum employer contributions to these mutual entities and minimum benefit payouts by these mutual entities are set by the Compensation Commissioner. At present, Federated Employee Mutual (FEM) and Rand Mutual Assurance (RMA) are the sole private entities licensed to provide employee compensation. FEM covers the construction industry, and RMA covers the mining industry. FEM provides benefits solely as required under COIDA; whereas, RMA provides COIDA as well as additional death/injury benefits. Both entities pre-date COIDA.

Current tax treatment
A specific income tax exemption exists for Compensation Fund under COIDA, thereby allowing for the tax-free growth of the fund. Benefit payouts to employees in terms of COIDA are similarly exempt. The entity level exemption for the build-up of funds does not apply to private mutual entities licensed under COIDA, but benefit payouts by these entities made in terms of COIDA are exempt.

The Compensation Fund cannot register for Value-added Tax (VAT) because the Fund operates as a regulated entity under the Public Finance Management Act. Both private mutual entities qualify as vendors under the VAT with premiums payable by employers subject to the VAT just like the payment of any other insurance premiums.

II. Reason for change

As discussed above, although private mutual funds operating under COIDA can provide income tax-free COIDA benefits, no specific comparable income tax exemption exists for the mutual fund build-up of reserves. No reason exists for this uneven treatment, especially to the extent these private mutual entities act in substitution of Government. Similar parity should also exist for VAT. Income Tax and VAT parity of treatment is important to ensure that these entities are not forced to increase premiums or offer lower benefits vis-à-vis the Compensation Fund for the same COIDA benefits

III. Proposal

In view of the above, it is proposed that the relief currently afforded to the Compensation Fund under COIDA be extended to the mutual associations licensed under COIDA. However, in order to receive this entity-level income tax exemption, these licensed mutual entities must solely provide COIDA-required benefits (without any benefits in excess of these amounts). This same condition is required for these mutual entities to be free from VAT registration.

Therefore, FEM will become free from Income Tax and VAT as a result of the proposed amendments. RMA, on the other hand, can only receive the same Income Tax and

VAT exemption if the benefits provided in excess of COIDA requirements are segregated from RMA into another entity.

IV Effective date

For income tax purposes, the proposed amendment will be effective for years of assessment commencing on or after 1 January 2011. For VAT purposes, according to general principles, the proposed amendment will apply to all services supplied on or after the date of promulgation of the Bill.

2.10 JUDICIAL LONG DISTANCE COMMUTING

[Key provision: Paragraph 7(8) of the Seventh Schedule]

I. Background

A taxable fringe benefit arises when employees use employer-owned vehicles for private purposes. Taxation of this fringe benefit is reduced by the distances travelled for business purposes. Daily work commuting (i.e. travel between the taxpayer's place of residence and place of employment) is not viewed as business travel. Taxpayers claiming the motor vehicle allowance similarly cannot claim the allowance against daily work commuting.

II. Reason for change

Many judges face a unique work commute situation. Judges are often required to serve various courts, many of which are spread far and wide from one another. For instance, some judges may be required to travel long distances to reach the district courts versus the Supreme Court of appeal in Bloemfontein in order to carry out their duties. These judges cannot be expected to regularly shift homes to shorten their shifting work locations. In order to alleviate this situation, judges are afforded the use of Government-owned vehicles to complete these various journeys as part of their compensation packages.

In 2010, the fringe benefit rules for motor vehicles became substantially more restrictive to prevent taxpayers from obtaining undue benefits in respect of employer-provided vehicles. These changes have had the unfortunate effect of adversely impacting judges who utilise Government-owned vehicles for long-distance work commuting.

III. Proposal

Due to their unique circumstances, judges will be allowed to treat their daily work commute as business travel for purposes of determining the fringe benefit impact of employer-provided vehicles. Like all other taxpayers claiming work-related travel, judges will be required to maintain a logbook to record the distances associated with their work-related travel (which will now include work commuting). Judges can claim fringe benefit relief on assessment or obtain monthly relief from Pay-As-You-Earn withholding (by virtue of the 80/20 relief mechanism).

IV. Effective date

Comes in operation on the date determined by the Minister.

3 INCOME TAX: BUSINESS

3.1 ISLAMIC FINANCE: EXTENSION OF MURABAHA

[Key provisions: Section 24JA(1)("Murabaha" definition)]

I. Background

Legislation was enacted in 2010 that recognises certain forms of Islamic finance as equivalent to traditional finance entailing interest. One of these products involves Murabaha arrangements.

The Murabaha is a mark-up financing transaction generally offered by financial institutions to ensure that a client can obtain financing for the purchase of various assets (e.g. fixed property and equipment). The financial institution will purchase an asset (from a third party) at the instruction of the client and sell the asset to the client at a pre-agreed price. The pre-agreed price represents the cost of acquisition of the asset plus a "profit" mark-up.

Under the 2010 legislation, banks offering finance pursuant to a Murabaha arrangement are deemed not be involved in the acquisition or disposal of the asset that is the object of the arrangement. The client is deemed to be acquiring the asset directly from the seller for the cost incurred by the bank (on the client's behalf) and at the time the bank acquires the asset. This deeming of a direct acquisition by the client eliminates adverse indirect tax (e.g. Value-added Tax) consequences for the bank that do not exist in the case of traditional finance. The "profit" mark-up allocation by the bank is deemed to be interest. It should be noted that the same principles explicitly apply to Murabaha arrangements that entail financing by collective investment schemes to banks.

II. Reasons for change

As stated above, the current ambit of the Islamic finance provisions dealing with Murabaha arrangements cater mainly for 'bank-to-client' finance. These Islamic finance provisions do not generally apply to arrangements in which the bank borrows funds from other parties. After further analysis, it has been decided that no reason exists to limit this form of Marabaha (deposit) finance. Whether the bank offers the finance or receives the finance (as a deposit) should make no policy difference. In either circumstance, the Marabaha arrangement is seeking to achieve the same equivalent result as traditional financing.

III. Proposal

It is proposed that the scope of Murabaha arrangements be extended to cater for clients that provide financing (e.g deposits) to the bank.(Hence, all legal entities and natural persons can now benefit from Marabaha financing to or from banks). In the newly added situations of providing finance (e.g deposits to banks). Income Tax, the profit mark-up for the client making a Murabaha deposit will be treated as interest for income tax purposes. In terms of indirect tax (Value-added Tax, Transfer Duty and the Securities Transfer Tax), the client's formal involvement with the asset is ignored with the asset being deemed directly acquired by the bank.

It should be further noted that anomalies exist within the current Murabaha arrangement framework in relation to certain indirect taxes (e.g. the Securities Transfer Tax) that arguably prevent the legislation from having the desired non-adverse result. These anomalies will be eliminated.

I.V Effective date

This amendment will become effective once all the Islamic finance legislation becomes effective.

3.2 PROPOSED GOVERNMENT SUKUK

[Key provisions: sections 24J((d) of the "interest" definition) and 24JA ("Sukuk" definition)]

I. Background

In 2010, Government introduced several provisions dealing with the tax treatment of Shariá compliant arrangements. These provisions mainly provide parity of tax treatment between Islamic finance products vis-à-vis conventional banking products. As part of this reform, the tax system now accommodates the following forms of Shariá compliant arrangements: (i) "diminishing musharaka", (ii) "mudaraba", and (iii) "murabaha". The net effect of these accommodations is to treat these forms of Sharia compliant financing as comparable to conventional "debt instruments", thereby eliminating anomalies relating to income tax, value-added tax (VAT), transfer duty and securities transfer tax.

II. Reasons for change

Creation of an enabling framework for Islamic finance requires more than enacting accommodating tax legislation. Islamic financing, like conventional financing, requires government bonds as a "risk-free" standard so as to set pricing for all other privately issued Islamic bonds. Moreover, Islamic finance providers typically utilise (and even require) Government bonds for regulating cash-flow and for otherwise balancing their portfolios.

In the case of banks, the need for Government-issued Islamic bonds is more acute. All banks must hold a certain percentage of investments in interest bearing instruments (including Government bonds) in terms of banking regulations. Yet, Islamic banks are religiously precluded from yielding economic benefits from interest bearing investments according to Shariá law, even if required by local banking regulations. In order to balance both religious and regulatory interests, truly proper Islamic banks surrender the interest received in respect of these investments. This lack of return places Islamic banking at a competitive disadvantage in comparison with conventional banks, thereby lowering the overall yield of Islamic savings products.

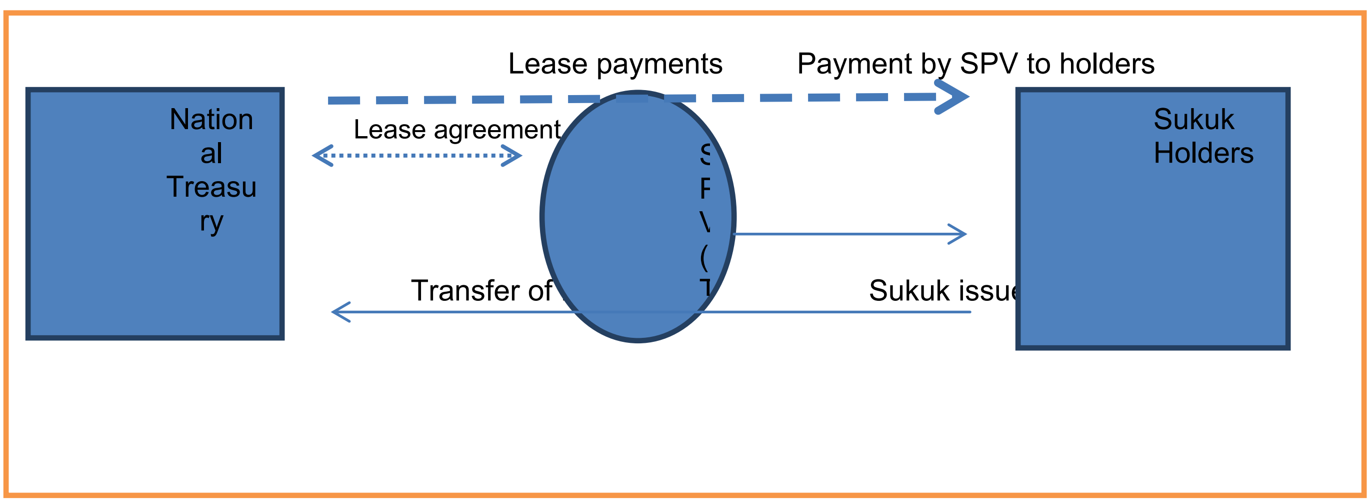
To date, Government has never issued any form of Islamic bond (known as a Sukuk). Moreover, current tax legislation fails to accommodate any meaningful potential for Government Sukuk because these products typically come in the form of an "Ijara" financing arrangement. Ijara financing roughly equates to conventional finance leasing. While the tax system contains anti-avoidance rules to restrict certain practices associated with finance leasing, the tax system does not treat financing leasing as equivalent to interest.

III. Proposal

Proposed Government Sukuk

In view of the above, Government plans to issue a Sukuk to serve as a central focal point for Islamic finance. This Sukuk will come in the form of Ijara so that the bond falls within the dominant global standard for Government issued Sukuks. At this stage, the bond is planned to be issued locally. Strong take-up is expected by local banks and other financial institutions actively engaged in Islamic financing. Demand for local Islamic bonds also exists from certain retail investors.

In essence, an Ijara-styled Sukuk is an Islamic certificate of investment evidencing an investor's proportional beneficial interest in an underlying asset (or in a comparable usufruct). In the case of the product proposed, the structure envisaged by the National Treasury is as follows:



Step 1: Identification of immovable property (e.g. a government building or facility) for use by a special purpose vehicle (SPV) in the form of trust (i.e. acting as a conduit entity).

Step 2: Transfer of beneficial ownership (or a usufruct) in the immovable property to SPV. As part of this step, investors will provide funds to the SPV. These funds will then be passed onto National Treasury in exchange for the beneficial ownership (or usufruct) in the immovable property.

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Step 3: National Treasury will simultaneously lease back the beneficial ownership (or usufruct) over a period of years. The lease payments provided to the SPV will be allocated to the investors after subtracting an appropriate administration service fee. The lease charge will be based on the market-related cost of funding provided by the investors.

Step 4: At the close of the lease period, National Treasury will repurchase the beneficial interest (or usufruct) held by the SPV (with the final payments again being allocated among the investors). This repurchase price will effectively act as a maturity payment for the funds initially acquired by the National Treasury.

Note: The overall arrangement will be reviewed by Islamic scholars to ensure that the arrangement satisfies Sharia law.

Tax adjustments

Applicable tax principles of present law unfortunately work against the proposed Government Sukuk by triggering multiple adverse tax consequences that do not exist for conventional Government bonds. This tax burden will accordingly be eased so that the overall arrangement operates essentially as interest.

Under current law, the sale and repurchase by the National Treasury will itself qualify as a “debt instrument” for income tax purposes. As a result, any surplus in the repurchase price (i.e. if the repurchase price is higher than the initial sale price) will be treated as interest for tax purposes. In addition, it is now proposed that the yield on the underlying asset (e.g. immovable property) held by the SPV be similarly taxed as interest for income tax purposes. The net result is an overall yield taxed in the same manner as interest (comparable to conventional bonds). The deemed “interest” yield of the SPV will automatically flow-through to the investors by virtue of the fact that the SPV is an entity in the nature of a trust (i.e. is a conduit under current law).

The proposed amendments will also eliminate adverse indirect tax charges currently associated with the structure.

In particular, any potential transfer duties associated with the acquisition by the SPV will be eliminated. No transfer duties currently exist in respect of the repurchase by National Treasury because Government acquisitions are already exempt from transfer duty.

The initial transfer will not give rise to a VAT charge because the Government supplier does not qualify as a VAT vendor. However, VAT could arise in respect of the annual yield earned by the SPV (because the immovable property is commercial) and upon the repurchase. Both these aspects of the arrangement will have to be treated as “financial services” for VAT purposes so both transactions are deemed to fall outside the VAT net.

Like pre-existing Islamic arrangements of this nature, the proposed tax consequences of the Government Sukuk will apply only if presented as compliant with Sharia law when offered to general members of public. As a practical matter, this requirement can only be satisfied if approved by Islamic religious scholars. This requirement ensures that the arrangement is driven by religious motivation (with the sole intent of placing financial instruments of the Islamic faith on par with conventional financing products).

IV. Effective date

Once all the Islamic finance legislation becomes effective.

3.3 ASSET-FOR-SHARE TRANSACTIONS WITH EXCESS LIABILITIES

[Key provision: Section 42(8)]

I. Background

The reorganisation rollover rules cover a variety of transactions, including asset-for-share transfers (which typically involve company formations). The rollover rules essentially seek to ignore the tax on the transfer with the gain being deferred until a subsequent disposal.

The asset-for-shares rollover provisions provide special relief for the transfer of assets subject to (i.e. securing) debt. Rather than tax the transfer (as a deemed sale of the asset for the relief of debt), the debt is added to the gain/income on the shares received in the asset-for-share transaction only when the shares are ultimately disposed of by the transferor.

II. Reason to change

The asset-for-share assumption of debt rules are modeled after an older version of the capital distribution rules (pre-1 October 2007). Under these older rules, capital distributions did not trigger immediate gain, only greater gain when the shares at issue were disposed of by the taxpayer receiving the capital distribution. These deferred gain rules were abandoned in 1 October 2007 because these rules lead to avoidance (with taxpayer generating excessive negative base cost in shares never to be disposed of). The post-1 October 2007 rules instead triggered immediate part-disposal treatment for capital distributions, but this immediate part-disposal was simply unworkable for the asset-for-share assumption of debt rules.

As discussed elsewhere (see note on Capital Distributions), the revised capital distributions are being revised again so capital distributions are taxed more consistently with the underlying theory. This change requires a re-examination of the asset-for-share assumption of debt rules.

III. Proposal

The asset-for-share assumption of debt rules will be revised in line with the revised capital distribution rules (triggering gain only to the extent that the capital distribution exceeds the base cost in the share). Consistent with this approach, the debt assumption will be viewed as a capital distribution equal to the face value of the debt assumed (or the fair market value of contingent liabilities assumed). This deemed capital distribution will be deemed to arise in respect of the shares held by transferor upon the close of the day in which transfer occurs. If the transferor holds multiple classes of shares, the capital distribution will be deemed to arise in respect of the class of shares for which the debt secured asset is transferred.

Example
Facts: Taxpayer owns 10 000 ordinary shares in a wholly owned company with those shares having an aggregate base cost of R120 000. Taxpayer transfers land with a base cost of R100 000. The land is subject to (i.e. acts as security for) debt of R150 000. Taxpayer receives an additional 5 000 ordinary shares from the company for the debt secured land.

Result: The R150 000 debt assumption is applied against the total base cost in the ordinary shares. The net result is no gain, but Taxpayer's total base cost in the shares is reduced to R70 000 (R220 000 less R150 000).

I.V Effective date

The proposed amendment is effective in respect of transactions entered into on or after 1 April 2012.

3.4 SINGLE CHARGE FOR EMIGRATION

[Key provision: Section 9H]

I. Background

A company can be said to have migrated when that company ceases to be tax resident in South Africa. One method for effecting this migration entails a company shift of its place of effective management to another tax jurisdiction (even if the company continues some or all of its operations in South Africa). This re-domiciling from South Africa to a foreign jurisdiction triggers certain tax consequences.

At the company-level, the corporate migration of effective management is deemed to be a disposal for capital gains tax purposes. In particular, the migrating company is deemed to have generally disposed of its assets at market value on the day before ceasing to be a resident and repurchasing those same assets at the same market value. However, assets that remain within the capital gains tax net will be excluded from this deemed disposal (and market value repurchase) treatment.

A corporate migration additionally triggers a deemed dividend for purposes of the Secondary Tax on Companies. This deemed dividend treatment is limited to company profits and reserves immediately before the company ceases to be a resident. Many aspects of this deemed dividend treatment have been carried over into the Value Extraction Tax (to be imposed when the new Dividends tax comes into effect).

II. Reason for change

When a company migrates, the event can theoretically be viewed in one of two ways - firstly as a sale and repurchase of assets by the entity, or secondly as a liquidation followed by a reincorporation. The current policy regarding the migration of companies, however, is somewhat inconsistent combination of both concepts. The imposition of a tax on dividends is also problematic at the shareholder-level because these shareholders do not receive any cash at any point during the migration. A simplified regime is therefore required that is both more theoretically defensible and more administratively viable.

III. Proposal

It is proposed that a single set of company-level tax be imposed when a company ceases to be South African tax resident by virtue of a change in effective management. This event will trigger either capital gain or ordinary revenue. No deemed dividend treatment will result.

More specifically, assets held by the existing company on the day before cessation as a resident will be deemed disposed at arm's length value as at that date. All these assets will then be deemed repurchased at the same market value. Appreciating assets held as trading stock will trigger ordinary revenue; appreciating assets of a capital nature will trigger capital gains (and possibly recoupment). As under existing law, exceptions will exist for assets remaining within South African taxing jurisdiction and for certain share incentive schemes. It should be noted that this new regiment apply to all residence shifting their tax residence abroad (not just companies).

IV. Effective date

This proposed amendment will be effective for cessations occurring on or after 1 April 2012.

3.5 ASSUMPTION OF CONTIGENT LIABILITIES: TAXABLE COMPANY ACQUISITIONS

[Key provisions: Sections 1 (definition of "gross income"), Section 11F; section 24CA; paragraphs 20(1)(a) and 35(1) of the 8th Schedule]

I. Background

Commercial and basic planning considerations

Choice of asset or share sale

In the case of a company, the sale of a business can be achieved either by the disposal of shares held in the company or by the disposal of assets of the company. In the case of a sole proprietor, the business sale can be achieved by solely selling the asset of the proprietorship. The purchaser of a business typically prefers to acquire the assets of the seller because the purchaser has a choice as to which liabilities to assume and which to leave behind.

Due to the risks associated with any liabilities assumed, most businesses are acquired through asset acquisition (as opposed to share acquisition). Asset acquisitions are especially prevalent in the case of smaller businesses, wherein the risks of the unknown for the purchaser are viewed as higher.

Price allocation

In the case of taxable asset acquisitions, allocation of the overall purchase price among the individual business assets is an important question for both seller and purchaser. The seller generally seeks to allocate the purchaser price in favour of capital assets to reduce the tax on sale (from ordinary rates to capital rates). The purchaser, on the other hand, prefers to allocate cost to ordinary assets because these ordinary assets generally give rise to ordinary deductions (e.g. through depreciation) or reduce ordinary gain (e.g. an increased cost price in trading stock).

Price allocation is generally done in one of two ways. Both the purchaser and seller can mutually agree to allocate the cost of specific assets within the business. In the absence of an agreement (more prevalent in the sale of small businesses), each party to the sale is free to choose a separate allocation.

Assumption of fixed and contingent liabilities

Assumed business can either be fixed or contingent in nature. Typical contingent liabilities of a business include post-retirement medical and annuity commitments, warranty claims for trading stock, employee bonuses, future maintenance contracts and environmental claims. Accounting breaks contingent liabilities into liabilities in which expected payment is probable or in which expected payment is remote.

In a taxable business acquisition, assumption of fixed and contingent liabilities is a matter of negotiation. In the simplest case, the seller obtains the full purchase price in cash, remaining responsible for payment of all liabilities. Alternatively, the cash price can be reduced by set off with the purchaser assuming some or all fixed and/or contingent liabilities associated with the business.

II. Reason for change

Contingent liabilities as consideration

The tax treatment of fixed liabilities assumed is clear when assumed by a purchaser as part of a business acquisition. Fixed liabilities assumed increase potential gross receipts and/or capital gain proceeds on sale as if the fixed liabilities assumed are comparable to cash consideration. In respect of the purchaser, fixed liabilities assumed are allocated among the tax cost of individual business assets acquired in the same manner as cash consideration.

However, the law is unclear as to the treatment of contingent liabilities assumed. While contingent liabilities should bear roughly the same impact in respect of a business sale as the assumption of fixed liabilities, the law is somewhat uncertain.

Deductions associated with contingent liabilities assumed

If contingent liabilities are assumed as part of a business acquisition, the liabilities at issue are initially incurred by the seller but ultimately paid by the purchaser. At issue is which party obtains the relevant deductions. In this regard, different interpretations exist, as follows:

Some take the position that the seller may claim these deductions;

Some take the position that the purchaser may claim these deductions;

Sometimes, both parties take these deductions; and

Some parties are concerned that neither party is eligible for these deductions.

The recent decision in Ackermans limited and Pep stores (SA) Limited v CSARS has added to the confusion.

III. Proposal

Contingent liabilities as consideration

The proposal seeks to remove the uncertainty pertaining to the tax treatment of assumed contingent liabilities when determining the total consideration of a business sale. Contingent liabilities (like fixed liabilities) will now explicitly be added to the total consideration for both the seller and the purchaser.

The seller will add these assumed contingent liabilities to gross receipts and/or proceeds on sale (depending on whether the applicable consideration is allocated to trading stock or capital assets). This treatment will mirror fixed liabilities assumed with one deviation. In the case of contingent liabilities, the addition to gross receipts/proceeds will be based on the fair market value of those liabilities (as opposed to the face value calculation in respect of fixed liabilities assumed).

The purchaser will similarly add assumed contingent liabilities as consideration. These amounts will be added to cost price and/or base cost (depending on whether the applicable consideration is allocated to trading stock or capital assets). As with the seller, contingent liabilities are taken into account at fair market value (as opposed to face value).

Deductions associated with contingent liabilities assumed

The proposal also seeks to remove the more pressing issue as to whether the seller or purchaser can deduct contingent liabilities assumed. In particular, the law will be clarified to state that the seller should claim the deduction (with the reduced cash consideration on sale viewed as a cost "actually incurred" in "carrying on any trade").

While clarifying that the seller is the proper party to claim the deduction, a special regime will be designed to prevent the purchaser from making the same claim. Under this special regime, the value of contingent liabilities assumed will initially be included in the gross income of the purchaser. The purchaser will simultaneously be provided with an upfront allowance of the same amount. This allowance will be added back and rolled forward during the post-acquisition years. This allowance (and associated add-backs) will reduce as payments in respect of contingent liabilities materialise or become remote. This allowance/add back system will create a more transparent mechanism for tracking the status of contingent liabilities assumed.

Example 1:
Facts: Purchaser acquires a business with cash while assuming contingent liabilities relating to warranties in respect of associated trading stock acquired. The purchase price allocable to the trading stock equals R400 000. Of this amount, R280 000 represents cash consideration; the remaining R120 000 represents the value of contingent warranties assumed (all of which are viewed as "probable" as opposed to "remote").

Result: The cost price of the trading stock is R400 000. Purchaser is deemed to receive R120 000 of income in respect of the contingent liabilities assumed. This inclusion in gross income is matched by a corresponding allowance of R120 000.

Example 2:
Facts: The facts are the same as Example 1, except that Purchaser pays warranties in the amount of R40 000 in the following year.

Result: Purchaser adds-back the R120 000 allowance from the prior year. The Purchaser then deducts the R40 000 paid plus R80 000 for the allowance rolled-forward. The following year begins with an add-back of R80 000.

IV. Effective date

The proposed amendment will be effective for disposals and acquisitions occurring on or after 1 January 2012.

3.6 INCENTIVE: INDUSTRIAL POLICY PROJECT REVISIONS

[Key provision: Sections 12I(2)]

I. Background

An additional tax allowance (on top of the normal allowances available) for industrial policy projects was introduced in 2008 to benefit all manufacturing projects. The purpose of the incentive is to support industrial development by attracting large industrial projects. The incentive offers special tax benefits to greenfield investments (i.e. new industrial projects) and brownfield investments (i.e. expansions or upgrades of existing industrial projects) with enhanced emphasis on the former. In order to receive this allowance, approval from an adjudication committee is required, which makes its determination based on pre-determined criteria with the committee approvals restricted to R20 billion of deductions for all industrial projects in total.

The main focus of the incentive is to promote capital expenditure. Greenfield projects receive an additional 55 per cent allowance, and brownfield projects receive a 35 per cent additional allowance. The allowances, however, are subject to certain limitations. A ceiling on the allowance of R900 or R550 million per project is imposed for greenfield projects (depending on whether project is preferred or merely qualifying). A ceiling on the allowance of R500 or R350 million per project is imposed for brownfield projects (depending on whether project is preferred or merely qualifying).

A secondary focus of the incentive is skills training. Training effectively receives a double deduction for up to a six-year period. The additional training deduction is subject to two ceilings – a ceiling of R36 000 per employee and a R30 million or R20 ceiling per project (depending on whether project is preferred or merely qualifying).

II. Reasons for change

Government is seeking to renew its efforts to enhance the Industrial Development Zone (IDZ) regime initiated by the Department of Trade and Industry. The purpose of the IDZ regime is to encourage industrial development within certain geographical areas. Yet, the additional allowance for industrial projects barely takes the IDZ into account (awarding only one point for an IDZ location when the adjudicating committee reviews applications via the regulatory criteria).

Early Government experience with the incentive also reveals some small shortcomings. These shortcoming exist in both the legislation and in the accompanying regulations.

III. Proposal

Promotion of IDZ’s

In view of the above, the industrial project allowance will be enhanced in respect of IDZ’s. Instead of a 55 per cent additional allowance for greenfield projects, the additional allowance for greenfield projects will be increased to 100 per cent. Instead of a 35 per cent additional allowance for brownfield projects, the additional allowance for greenfield projects will be increased to 75 per cent. The regulatory point scoring criteria will also be shifted to enhance approval (and preferred status) within IDZ areas.

Minor anomalies

Under current law, additional capital incentives for industrial projects are subject to an overall R20 billion ceiling as stated above. However, the training allowance lacks any comparable aggregate ceiling. Training allowances will accordingly become part of the same aggregate ceiling to ensure the costs of the incentive are better controlled by Government.

The incentive also does not prevent deadweight loss to the fiscus as intended. The incentive is for projects that would not otherwise occur. In that vein, it was always intended that possible approval be given only toward projects that are acquired and contracted after the approval date. The wording suggests otherwise and will accordingly be corrected.

IV. Effective Date

The proposed amendments will be effective for projects approved on or after 1 January 2012.

3.7 INCENTIVE: VENTURE CAPITAL COMPANY REVISIONS

[Key provision: Section 12J]

I. Background

Government enacted the venture capital company (VCC) tax regime in 2008. The purpose of the VCC is to create a pooling mechanism for investors to channel funds into small businesses and junior mining operations. The VCC itself (based on the private equity model) is intended to act as an "angel investor" for these small businesses and junior mining companies by providing equity and supportive management services. The VCC is expected to typically acquire a major stake in these entities until these entities reach a certain level of growth with the VCC selling these entities for profits upon the entity's maturity. The VCC model requires this incubation period to last between 5 and 10 years. Most of the small businesses and junior mining operations involved are high risk – with a few large "winners" generating profits that should exceed the lack of profit in respect of the remainder.

Taxpayers investing in a VCC generate an upfront deduction for the investment (whereas most equity investments are non-deductible) with a recoupment upon withdrawal. The VCC has three sets of requirements: (i) investor-level requirements for the deduction, (ii) criteria for determining whether the investor pooling entity qualifies as a VCC, (iii) criteria for determining whether the VCC is investing in a qualifying small business company or a junior mining company. The VCC itself requires pre-approval from SARS to initiate operations.

II. Reasons for change

To date, the VCC regime has not been successful. Applications have been few and no VCC has been successfully initiated to date. It is contended that the investment benefits are too small, and the VCC, small business and junior mining criteria are too restrictive. The restrictive criteria mean that the VCC cannot operate in accordance with the private equity model upon which the regime is founded. The lengthy restrictive criteria have also rendered the regime far too complex, making operation of the VCC unsustainable.

III. Proposal

Overview

Given the above concerns, a general relaxation of requirements is proposed so that investor pooling of equity funds through VCC can be achieved as intended. The general relaxation will also balanced with minimal anti-avoidance requirements to ensure that the regime does not give rise to tax deductions that private little or no meaningful assistance to the target group intended.

Investor criteria

The general ceilings and prohibitions associated with investors seeking a deduction will be completely removed. The current "natural person" limitation will be removed, meaning that all taxpayers (e.g. legal entities) can now freely obtain deductions for investing in a VCC. The R750 000 investment and other ceilings will be similarly removed.

In lieu of the above criteria, three anti-avoidance criteria are added.

Firstly, the deduction will not be available to investors who become connected persons to the VCC as a result of, or upon completion, of the investment. As a practical matter, the connected person test is generally triggered at a more than 50 per cent level or 20 per cent level depending upon the facts. These rules ensure that taxpayers cannot obtain a deduction merely by cycling funds among closely connected parties (as opposed to obtaining new independent investment).

Secondly, the deduction will only be allowed if the investments in the VCC are pure equity investments (investments with debt-like features will be completely disallowed). In essence, the channeled funds must bear the economic risk and loss associated with the profit model of the VCC.

Thirdly, the investment must place the investor genuinely "at-risk." No issue arises if the investor funds the investment from the investor's own resources. However, if the investment stems from a loan or a credit facility, the investor must bear the risk of the loan or the credit facility (i.e. the loan or credit facility must be a fully recourse loan that must be repaid even if the VCC does not reach the investment objectives intended). Moreover, a loan or credit facility will not be deemed to satisfy the "at-risk" criteria if the loan or credit facility is provided or guaranteed by the VCC or a connected person to the VCC. Loans or credit facilities must also be repayable within 5-years to avoid "time-value of money" schemes (schemes where the repayment is delayed for so long that the repayment is meaningless after inflation is taken into account).

Venture Capital Company Criteria

The VCC criteria will be significantly relaxed. The goal again is to simplify the regime by eliminating overly burdensome requirements. More specifically, the following amendments are proposed:

Firstly, VCCs will not be disqualified merely because the VCC lists on the JSE. The goal is to pool private investments; no reason exists to prohibit this form of pooling.

Secondly, the VCC can now be part of a group (either a controlled group company or a controlling group company). However, note that deductions for investors are limited to persons who are not connected persons (see above) and that some ownership limitations still exist in respect of qualifying (small business or junior mining) investments (see below).

Thirdly, the prohibition against having more than 20 per cent passive income in a single year will be dropped so that temporary cash build-ups do not undermine the regime. However, the VCC must still spend at least 80 per cent of its expenditure for qualifying (small business and junior mining) companies from date of the VCC's approval from SARS. The 80 per cent requirement should be sufficient by itself to ensure (by applying objective principles) that the VCC is directed to its objective.

Fourthly, the minimum investment requirements will be dropped as contradictory to the regime. The VCC will no longer be required to invest a minimum of R30 million to acquire a (small business) qualifying company or a minimum of R150 to acquire a (junior mining) qualifying company.

Fifthly, the diversification requirements will be slightly eased. Under current law, the VCC can invest no more than 15 per cent of its total expenditure in any one qualifying (small business or junior mining) company. The percentage will be increased to 20 per cent. Hence, a VCC can satisfy the minimum criteria by investing in no more than five qualifying companies.

Qualifying (investee) companies

The rules associated with qualifying (investee) companies will be relaxed. In the main, a VCC must invest at least 80 per cent of its expenditure in qualifying (investee companies). At present, qualifying (small business) companies cannot have a book value exceeding R10 million and qualifying (junior mining) companies cannot have a book value exceeding R100 million. These maximum thresholds are unrealistically low and will accordingly be increased. It is proposed that the maximum book value threshold for qualifying (small business) companies cannot exceed R20 million and qualifying (junior mining) companies cannot exceed R300 million.

The qualifying company ownership restrictions are also being relaxed. Under current law, qualifying investee companies may not be more than 50 per cent owned by the VCC. This requirement runs counter to the VCC (private equity) model because private equity funds often maintain temporary control of qualifying companies during the incubation period for enhanced management. The ownership prohibition will accordingly be relaxed so the VCC can own up to 70 per cent. The 30 per cent limitation ensures that the small business attracts independent players.

As a final matter, the prohibition against franchisees will be dropped. VCCs can now freely invest in qualifying (small business) companies operating as franchisees. Small businesses of this nature often need outside equity support to initiate or expand operations.

IV. Effective date

The proposed will be effective for expenditures paid or incurred to acquire shares of a VCC for taxpayer years of assessment commencing from 1 January 2012.

3.8 INCENTIVE: RESEARCH AND DEVELOPMENT REVISIONS

[Key provision: Section 11D]

I. Background

Overview

The income tax system contains an incentive for R&D in order to promote increased private sector R&D investment in South Africa and enhance its role as an R&D and innovation location and to generally promote R&D and innovation led industrial development and job opportunities. The incentive has two main aspects: (i) a 150 per cent deduction for R&D non-capital expenditure, and (ii) an accelerated 50:30:20 per cent write off over three years for R&D buildings, plant, machinery, utensils, articles and improvements.

R&D non-capital expenditure (150 per cent)

In order for R&D non-capital expenditure to be entitled to a 150 per cent deduction, this expenditure must be directly attributable to R&D undertaken in South Africa. R&D can either be: (i) the discovery of novel, practical and non-obvious information, or (ii) the devising, developing or creation of inventions, designs, computer programs or knowledge essential to the use thereof. R&D must additionally be of a scientific or technological nature, and must either be: (i) used for production of the taxpayer's income, or (ii) discovered, devised, developed or created for purposes of deriving the taxpayer's income.

The legislation also contains certain "exclusions" such as the following: exploration and prospecting relating to minerals or oil and gas, management or internal business processes, trademarks, social sciences or humanities, or market research or sales or marketing promotion. Banking, financial services and insurance businesses are excluded per se from the relief.

Accelerated (50:30:20) write offs

Buildings, plant, machinery, implements, utensils and articles obtain a 50:30:20 write off over three years if dedicated to R&D. The definition of R&D for this purpose (as well as the "exclusions" noted above) is the same as the definition for non-capital expenditure. The rules for this write-off are consistent with other accelerated write-offs (including potential recoupment upon disposal that effectively recaptures prior write offs).

R&D third-party funding arrangements

Parties undertaking R&D activities often do so on behalf of others (those funding the activities). To the extent these circumstances exist, the parties funding the R&D obtain the 150 per cent deduction as opposed to the parties undertaking the R&D activities. However, the 150 per cent deduction shifts to the party undertaking the activity if the funder cannot deduct the amount funded (e.g. because the funder is tax-exempt or outside the tax system).

II. Reason for change

As is common place internationally, the lack of a concrete and precise definition of R&D has given rise to of the following problems:

Firstly, concerns exist that while the definition has been broadened to cover as many industrial R&D activities as possible, there are still specific areas that are unclear. This gives rise to a need to clarify the industry-activities and expenditure related to R&D that are eligible to qualify.
Secondly, legitimate value-add R&D is often subject to unnecessary uncertainty and audit scrutiny. Moreover, increased involvement from the Department of Science and Technology is arguably required because the tax incentive effectively amounts to an indirect Government grant. This includes the unclear role of SARS of determining the eligible activities;

Uncertainty surrounds the process in order for companies to benefit from the incentive. To this end, taxpayers who have submitted forms have no way of knowing immediately if their claim for the allowance have been approved or not.

On the technical side, the incentive continues to give rise to certain anomalies. One recurring issue is how to ensure that the incentive is properly applied when the R&D is funded by outside parties. In this circumstance, funder payment for R&D services undertaken by another is unnecessarily giving rise to an audit claim that the funding mechanism amounts to a recoupment (thereby making R&D services performed on behalf of another non-economic).

III. Proposal

Approvals committee processes

The approvals committee for R&D projects and assets will operate much the same way as the adjudication committee relating to the Industrial Policy Project incentive. The committee must not only review the initial approval for recommendation to the appropriate Minister (DST in this case) but also engage in monitoring and reporting on an annual basis. The approvals committee will consist of five members appointed by the Minister of Science and Technology and three members appointed by the Minister of Finance. The respective committee appointees must be “persons full-time employed by the Department of Science and Technology” and “persons full-time employed by the National Treasury or the South African Revenue Services”.

The Minister of Science and Technology or the Minister of Finance, as the case may be, may appoint alternative persons so employed if any person appointed is not available to perform any function as a member of the committee.

Applications procedure

All application for approval under Section 11D R&D incentive must be made to the DST, in a prescribed form, containing information prescribed by the DST for submission. The approvals committee will evaluate all applications and make a determination to approve any application as constituting eligible research and development activity in terms of the provisions of Section 11D of the Act. Approval and procedural guidelines for the committee must be released by DST with concurring consent from the Minister of Finance.

IV Effective date

The proposed legislation will be effective for expenditures incurred on or after 1 April 2012 but before 1 April 2017.

3.9 INCENTIVE: FILM PRODUCTION REVISIONS

[Key provision: Section 12O

I. Background

Film tax allowance

South Africa's income tax system contains an incentive to stimulate the production of films within South Africa. The current incentive comes in the form of an allowance (i.e. a 100 per cent upfront deduction for film production that would otherwise be non-deductible as capital in nature). However, if the investor supplying the funds obtains those funds through borrowing, the deduction applies only to the extent that the investor is at risk in respect of that borrowing. The allowance contains a myriad of requirements, many of which seek to ensure that the costs relate to production while others seek to ensure that the film is largely local in nature.

South African Film and Television Production and Co-Production Incentive from the Department of Trade and Industry (DTI)

In order to provide South African film production with initial cash-flows that are designed to operate as a catalyst for investment, the DTI provides an incentive for eligible films (called the South African Film and Television Production and Co-Production Incentive, which became operative on 30 June 2004). The funds of an awarded incentive are released in tranches based on the fulfilment by the producers of certain film production milestones. To this end, incentive funds are typically only awarded once the investors have made an initial injection of their own funds (toward the total production budget) with additional DTI incentive funds added as specified film milestones are reached. In particular, equal amounts of the incentive are disbursed in tranches upon:

The date that confirmation that the completion bond is registered;
The date that principal photography commences;
The date that principal photography is complete;
The date of completion of the final mix (i.e. roughly the date that the film is ready for distribution); and
The date that the applicant submits the final claim to the DTI.

The DTI incentive also contains certain procedural criteria (see DTI programme guidelines for South African Film and Television Production and Co-productions issued 28 January 2008). These criteria include the required creation of a domestic company to act as a special purpose corporate vehicle (SPCV). The purpose of the SPCV is to separately account for DTI funding (and investor funding) as applied to film production costs (in terms of financial reporting and in terms of other requirements such as black economic empowerment). The Income Tax Act contains ancillary rules in support of the DTI incentive by treating the incentive as exempt income for the SPCV. The Income Tax Act additionally allows the incentive to be passed tax-free to the film owners.

Investor access to the DTI incentive typically occurs in the form of a loan repayment, a cession, or as a dividend from the SPCV. Investor involvement with the SPCV generally depends on whether the DTI incentive is awarded before or after film production.

If film production begins after having secured the DTI incentive, investors make an initial loan to the SPCV so that the SPCV can use investor funds to make the film. The investors are then repaid a portion of their initial loan as the SPCV collects the DTI incentive upon film production reaching certain milestones as outlined above.

If film production begins before having secured the DTI incentive, investors again make an initial loan to the SPCV upfront so that the SPCV can use investor funds to make the film with the loans partly repaid via the DTI incentive at the end of the process once DTI funds are secured.

It should be noted that no investor should ever receive more from DTI than a partial return of their funding. The DTI incentive is designed only as partial subsidy.

Nature of film income

The profits of film production come at several levels. As an initial matter, it is hoped that film profits are made through cinema release. Successful films typically generate subsequent profit through distribution via DVD or through television programming. Less than successful films go straight to DVD or television. Investors obtain the fruits of their investment through “exploitation rights” (that generate proportionate sales, licensing income and ancillary revenue).

Role of the collection account management agreement

Although producers and investors retain ownership of film production rights, the parties involved typically enter into a collection account management agreement with an independent third party (i.e. the collection account manager (CAM)). Basically, the primary function of the CAM is to administer the collection and distribution of revenues to investors arising from their "exploitation rights" (relating to cinema, DVD and television rights, etc.). The CAM function is one of pure agent for allocating funds among investors.

II. Reasons for change

The upfront allowance for film production has by-and-large been unsuccessful. To the extent the allowance has arguably assisted in certain local film productions, the incentive has been a deadweight loss. Still worse, the incentive has created fertile ground for tax schemes, whereby certain investors mainly sought to obtain deductions with little regard for the underlying film. In these circumstances, the allowance has been more of an incentive for tax advisors and other financial facilitators as opposed to genuine film production.

The main problem with the incentive is the incentive's emphasis on cost – the greater the cost, the greater the incentive. This emphasis has caused certain taxpayers to generate artificial losses. While "at risk" rules exist to curb this practice, it is questionable whether these rules have been fully effective.

At an audit level, SARS has properly sought to intervene in order to protect the fiscus. However, this intervention has meant that many legitimate investors have come to shy away from the incentive due to the audit risk. Still others continue to utilise the incentive with the goal of subsidising "cultural" films not intended for profit (i.e. as a self-styled deduction for amounts that would not be deductible if contributed to a public benefit organisation designed to promote culture).

III. Proposal

Overview

In view of the above, the film allowance will be wholly revised. The accelerated write-off will be removed and replaced by an exemption. More specifically, income from qualifying films will be wholly exempt. This change in focus will eliminate the incentive to escalate costs. Under the new regime, losses are irrelevant - the greater the profit, the greater the value of the exemption. The exemption will completely eliminate the income tax on film profits for a 10-year period.

Qualifying criteria

In order to receive the exemption, the following criteria must be satisfied:

The production must be derived from a film;
The film must be approved as a domestic production or co-production;
The income must be allocable to the initial investors;
The income must be derived in respect of exploitation rights; and
The income must fall within a 10-year period.
Film requirement

The production must qualify as a feature, documentary or animation as defined by the DTI programme guidelines (see DTI programme guidelines for South African Film and Television Production and Co-productions issued 28 January 2008). More specifically,

A feature film entails:

A film commonly screened as the main attraction in commercial cinemas;

A film with a duration of no less than 90 minutes (or in the case of a large format (IMAX) film, no less than 45 minutes); and

A film shot and processed to commercial theatrical release standards, for cinema exhibition or television broadcast, direct-to-video or DVD.

A documentary entails:

A non-fictional informative or educational programme or series recording real people or events that may involve some dramatisation;

A programme no less than 90 minutes in length (or in the case of a large format (IMAX) film, no less than 45 minutes); and

A programme shot and processed to commercial theatrical release standards for cinema exhibition, television broadcast, direct-to-video or DVD (including a series limited to 13 episodes).

An animation entails:

A sequence of frames that, when played in order at sufficient speed, presents a smoothly moving image for broadcast, projection, new media and network use in an entertaining, educational, informative or instructive manner; and

Hand-drawn images (2d animation), digitised video, computer-generated images (3D and flash animation), live action objects or a combination thereof.

Pre-approval required

As a second requirement, the feature film must be pre-approved by the National Film and Video Foundation (NFVF) in order to qualify for relief. Approval is available for both local productions and co-productions (the latter falling within the definition of a co-production film pursuant to formal agreement between South Africa and another country concerning the co-production of films). The NFVF will operate in an oversight and monitoring capacity to ensure that the exemption applies to genuine profit-seeking films with significant local South African content. This approval must be obtained by the date that principal photography for the film has commenced. To this end, all funding arrangements must have been similarly finalised by this date as a practical matter.

Initial investors

The exemption will apply in respect of exploitation rights held by persons on or before the date of NFVF approval. The exemption is limited to these initial investors because these parties are the ones taking the key risks. Successor investors join the production only after the income probabilities associated with the film are fairly certain.

In addition, the incentive does not apply to broadcasters as defined in section 1 of the Broadcasters Act, 1999 (Act No. 4 of 1999), and connected persons thereto. Investments in these scenarios contain a guaranteed level of profit because the films are produced merely for pre-determined sales or use by the broadcaster.

Example:

Facts: Investors A, B, C, D and E own the production rights to produce a local film, which is completed in 2014. After completion of production of the film, Investors A, B, C and D collect their proportionate exploitation rights (i.e. 20 per cent) to revenue from subsequent film sales to X who is a registered distributor. Investor E sells all allocable exploitation rights to Investor X for R120 000. The film generates income of R1 million after all disbursements are paid.

Result: Investors A, B, C and D obtain a full exemption in respect of their proportionate income of R200 000 since their income is earned pursuant to their exploitation rights held as of the date of completion. E obtains a full exemption in respect of R120 000 of the exploitation rights sold to Investor X. X's income of R200 000 is fully taxable after production since X acquired the exploitation right from E and was not the initial owner. A, B, C and D get a full exemption on their film income until 2024.

Exploitation rights
The rights at issue must relate to exploitation (sales and licensing) rights associated with underlying film. More specifically, the profits must be wholly dependent on the success of the film. Therefore, the exemption does not apply to the extent any payments fall below any guaranteed minimums.

These at-risk rules exclude income from set salaries and loan repayments. However, it should be noted that parties taking salary compensation in the form of exploitation rights need not sacrifice the exemption. The exemption fully applies as long as these rights are fully dependent on film profits.

Example:

Facts: A who is a film producer owns the production rights to produce a local film which is completed in 2014. Upon completion of the film, A has exploitation rights that entitles A to receive 10 per cent of the proceeds from film sales with a minimum of R100 000. The film generates a total of R3 million of income after all disbursements are paid.

Result: A's allocable income pursuant to his exploitation rights from film sales is R300 000. A will obtain a full exemption on the income of R200 000 but not on the income of R100 000 because this amount is guaranteed (i.e. probably linked to A's salary). A will obtain a full exemption on the income of R200 000 until 2024. A's salaried income of R100 000 will be fully taxable.

Ten-year period

As stated above, exempt film income lasts only for a ten year period. The ten year period begins on the date that the film production is completed (i.e. roughly the date that the film is ready for distribution). The exemption covers all receipts and accruals (i.e. in respect of all sale and licensing rights) associated with the film (e.g. cinema, DVD and television).

Procedural requirements

Like all newer incentives, a policy stance is taken that on-going reporting is required to measure the economic success of the incentive and to guard against tax avoidance. The NFVF will act as the key point for collecting information. Reporting must be done via the SPCV or by a CAM approved via regulation. Taxpayers will be given a choice so as to reduce their administration costs depending on their circumstances.

The reporting requirement will last for the same 10-year period as the potential exemption. Taxpayers will not be denied the potential exemption if they violate the procedural requirements noted above but will be liable for the payment of a penalty for breach of these requirements. The NFVF will in turn be required to report aggregate information to the National Treasury.

Losses and non-qualifying films

Expenditures and losses are no longer a consideration for qualifying films. Expenditures and losses cannot be deducted if the associated income is exempt (i.e. lacks production of income).

Non-qualifying films still produce taxable income. In order not to give non-qualifying films an incentive (or to be used as a means of resurrecting prior schemes), losses and expenditures associated with non-qualifying films will be ring-fenced. These losses can only be deducted against non-qualifying film income. In this regard, expenditures and losses can only be used against the income associated with the same non-qualifying film.

DTI incentive

The DTI incentive will remain exempt in the hands of the SPCV but only if the film subsidised is a qualifying film. The DTI exemption will also apply to amounts paid over by the SPCV to the initial investors but will be limited to the extent of the amount loaned or invested by the applicable investor in the film.

IV. Effective date

The proposed legislation will be effective for all receipts and accruals in respect of films in which principal photography commences on or after 1 January 2012 but before 1 January 2017.

3.10 SMALL BUSINESS: MICRO-BUSINESS TURNOVER TAX RELIEF

[Key provisions: 6th Schedule; paragraph 7 of Appendix 1]

I. Background

The turnover tax system seeks to encourage the informal sector and other small businesses to enter the tax system by lowering the barriers of entry associated with the standard tax system. In essence, small businesses under the turnover tax system are subject to a low rate of tax on a gross basis without deductions. The turnover tax potentially applies to businesses with an annual turnover of up to R1 million.

II. Reason for change

Two years after introduction, the objectives of the turnover tax have not been realised. Only a small number of taxpayers have registered for the turnover tax, most of which have migrated from pre-existing registration under the normal income tax. While all of the reasons associated with these difficulties are still under examination, certain design aspects of the turnover tax appear to be problematic. Most notably, the rate structure may be too high for many informal businesses. The prohibition from being registered under the value-added tax may also be partly to blame because many businesses must be so registered if they are to be viewed as credible by clients. The three-year lock-in period may also be a deterrent to businesses registering for the turnover tax.

III. Proposal

In view of the above, the attributes associated with the turnover tax will be enhanced. First and foremost, the rate structure will be alleviated. The turnover band to which the zero rate of tax is applicable will be increased from R100 000 to R150 000. The other rates will also be reduced from one, three, five and seven per cent down to one, two, four and six per cent. Secondly, the value-added tax and the turnover tax will be completely de-linked. Vendors registered under the value-added tax may now freely register under the turnover tax if these taxpayers believe that it is in their best interests to do so.

On a related note, SARS will be empowered to choose under which tax system to register informal businesses that fail to unilaterally come forward to register for tax. To the extent SARS uncovers a wholly unregistered informal business; SARS will have the power to register the business for turnover tax or income tax. This power will ensure that taxpayers cannot alternate between both tax systems as a mechanism to artificially slow the audit process. SARS will also have the power to note certain details of businesses and their owners if those businesses are not legally compelled to register for tax and submit tax returns.

Lastly, the three-year lock-in period will be relaxed by doing away with the exit and re-entry rules. This effectively means that a micro business can voluntarily exit the turnover tax system at the end of a year of assessment. However taxpayers that exit the turnover tax will no longer be allowed to re-enter the turnover tax system. The new system was not designed to be a "lesser of " system with taxpayers regularly switching between the normal and the turnover tax on an opportunistic basis to pay less tax.

IV. Effective date

Changes to the rates will be effective from years of assessment commencing from 1 March 2011. The other proposed amendments will be effective from years of assessment commencing from 1 March 2012, and where specified, 1 January 2012.

3.11 DEBT CANCELLATION: CHARACTER ISSUES

[Key provisions: Section 1 definition of "gross income" section 62]

I. Background

Debts are often cancelled for various reasons. Amongst others, the creditor may cancel a debt: (i) in return for services rendered, (ii) as consideration for the acquisition of an asset, (iii) out of gratuity or disinterested benevolence, or (iv) due to the debtor's inability to pay. The impact of these cancellations varies:

Ordinary revenue impact: In terms of the ordinary revenue provisions within the Income Tax Act, compromises or concessions reduce loss carryovers. If the debtor is wholly or partially released from a debt in respect of which an allowance or deduction has been previously claimed, the amount of debt from which the debtor is released will be treated as a recoupment and included in the debtor's gross income.

Donations tax impact: Debts cancelled by the creditor out of gratuity or disinterested benevolence attract donations tax at a rate of 20 per cent of the fair market value of the debt so cancelled.

Capital gains tax impact: Within the capital gains tax provisions, several debt cancellation provisions exist. Any amount of debt reduced or discharged is treated as proceeds received or accrued to the debtor if the debt reduction or discharge stems from the disposal of an asset. Debts reduced in respect of acquired assets trigger a reduction in expenditure in respect of that asset (or immediate capital gain if the asset has previously been disposed of). Lastly, any debts reduced or discharged for no or below-market consideration outside the above circumstances will give rise to capital gain (subject to certain exceptions).

II. Reasons for change

The tax impact of debt reductions or discharges is somewhat confused. In terms of ordinary revenue, the impact of these cancellations is divorced from the cause. No reason exists for treating debt reductions or discharges in this unique fashion when the tax impact of other forms of consideration relate to causal connection.

The impact of debt reductions of discharges in respect of the donations tax is also inconsistent with other debt reductions or discharges within the Income Tax Act. In particular, the donations tax focuses on market value as opposed to face value. The focus on market value is problematic because the market value of debt depends in part on the likelihood of repayment, leaving a tautological result. More specifically, if a debt is unlikely to be repaid, the debt's value is reduced without any donative (or ordinary revenue) impact.

III. Proposal

Income tax adjustment

It is proposed that a debt reduction or discharge be treated as a receipt or accrual equal to the face value of the debt reduction or discharge. This change means that certain forms of debt reduction or discharge will trigger gross income treatment (i.e. ordinary revenue) even if the debt did not previously give rise to an allowance or deduction. For instance, the reduction or discharge of debt in respect of services rendered will trigger ordinary revenue without regard to any prior allowance or deduction.

Debt reductions or discharges giving rise to gross income as a receipt or accrual will no longer be viewed as a recoupment (despite the fact that the debt reduction or discharge is associated with a prior allowance or deduction). This narrowing of the recoupment rule will prevent double taxation of the same reduction or discharge amounts.

Donations tax adjustment

For donations tax purposes, it is proposed that the amount taken into account in determining a debt reduction or discharge be based on the face value of the debt reduction. Fair market value will no longer be part of the calculation.

IV. Effective date

The proposed amendments will be effective for all cancellations or reductions occurring on or after 1 January 2012.

3.12 DIVIDENDS TAX: ACCRUAL VERSUS CASH ACCOUNTING

[Key provision: Section 64E (2)]

I. Background

The Secondary Tax on Companies ("STC") imposes tax on dividends declared by companies at a rate of 10 per cent with the company paying the dividend being liable for the tax. On 1 April 2012, the STC will be replaced with the Dividends Tax. The Dividends Tax imposes a liability at the shareholder level at a rate of 10 per cent.

Tax liability for the Dividends Tax will be triggered when the dividend is paid to the shareholder. The dividend will be deemed to be paid on the date on which the dividend accrues to the shareholder. Case law defines accrual as an unconditional entitlement to an amount. In the circumstance of listed shares, a shareholder typically becomes unconditionally entitled to a dividend on the last date of registration of the dividend by the company.

II. Reasons for change

In many cases (especially in the case of closely-held companies), the date of dividend declaration and the date of dividend payment are the same. However, a delay often exists between declaration and payment. This delay is most prominent in the case of listed companies with these companies using a "last date to register" as an interim date for settling dividend accrual. This issue can also arise in closely-held situations. For example, a closely-held company may declare a dividend far in advance of cash available to clear profits before the entry of new shareholders.

The difference in accrual versus payment dates often causes unique difficulties when applying tax withholding. Withholding agents (especially regulated intermediaries) cannot practically be expected to withhold cash on dividends without timely physical control over the cash. If foreign dividends from foreign shares listed on the JSE are involved, there is the added problem of foreign currency conversion. If the accrual date precedes the cash payment date, the Rand-to-foreign currency value might fluctuate so that the shareholder receives a different Rand value than the Rand value accrued.

III. Proposal

Because the concept of accrual often cannot be practically applied in the context of withholding, the timing rules will be changed in favour of actual/constructive payment. Under this revised concept, the Dividends Tax will be triggered:

When a actual payment of the dividend is made ("actual payment"); or

When either (i) the amount of the dividend due is set aside or made unconditionally available to the beneficial holder of the dividend, or (ii) the amounts due have been dealt with or otherwise utilised at the direction of the beneficial holder.

Example 1:
Facts: Listed Company declares a dividend on 01 March. The last date to register in respect of the dividend is 13 March. The date of payment of the dividend is 20 March.

Result: The payment (withholding) date is the actual payment date (20 March).

Example 2:
Facts: Company (an unlisted company) announces a declaration of a dividend on 01 March with the date of payment to be announced in the future (i.e. date of payment unspecified). On 15 August, a board decision is made for payment to occur on 1 November with the actual payment made accordingly.

Result: The payment (withholding) date is the actual payment date (1 November).

Example 3:
Facts: The facts are the same as Example 2, except that the dividend is ultimately cancelled before actual payment.

Result: The Dividends Tax never arises because the dividend is never actually paid.

IV. Effective date

The proposed amendment will be effective when the Dividends Tax comes into effect.

3.13 DIVIDENDS TAX: IN SPECIE DIVIDENDS

[Key provisions: Section 64EA and 64FA]

I. Background

Companies pay dividends in cash or in kind (i.e. the latter being referred to as dividends in specie). The Secondary Tax on Companies generally imposes tax on companies when declaring dividends. The Dividends Tax will replace the Secondary Tax on Companies. As part of this change, the Dividends Tax will shift liability onto shareholder and will include a withholding tax collection mechanism.

II. Reason for change

The taxation of in specie dividends poses administrative problems when the method of collection involves withholding. While the company paying the dividend can plan so as to set aside the cash needed to pay the tax for in specie dividends, withholding intermediaries will often not be in this position. Cash availability will be especially problematic for regulated intermediaries (e.g. central securities depository participants). Most regulated intermediaries are merely collection agents that are not otherwise required to hold substantial cash reserves.

Another set of issues relates to the valuation of in specie dividends. Values may be volatile even over short periods (especially if the in specie dividends consist of listed shares). The valuation rules currently in place also need to be considered at different levels beyond the Dividends Tax. Valuation will also be important in the case of determining company-level gain or loss in respect of the assets distributed and for determining the impact of in specie return of capital distributions.

III. Proposal

A. Domestic companies making in specie dividends

A set of special rules will be added for in specie dividends in view of the practical cash problems described above. In particular, the proposed shift of liability to a shareholder-level will not apply in the case of in specie dividends paid by domestic companies. Hence, under the new system, the company paying the in specie dividend remains liable for paying the tax. The withholding mechanism for in specie dividends of this nature will be rendered irrelevant.

Despite the shift in liability, in specie dividends will be eligible for the same exemptions as cash dividends. For instance, in specie dividends paid by domestic companies to domestic companies will be exempt like cash dividends. In order for the company payor to receive this exemption, the company must generally receive a declaration of exemption from the beneficial owner by the date that the dividend is paid. The only deviation from the declaration rule involves dividends paid to a domestic group company member; in this latter instance, the exemption applies automatically. Tax treaty relief is also available for in specie dividends with declaration from beneficial owners similarly required. Lastly, credits stemming from the Secondary Tax on Companies will be available to the same extent as those credits are available for cash dividends.

Administration of in specie dividends by domestic companies will operate under the same administration as cash dividends. For instance, the tax payment due date will remain the same (i.e. the last day of the month following the month in which the dividend was paid). However, no refunds are envisioned for late declarations.

IV. Effective date

The proposed changes will come into effect when the Dividends Tax comes into effect.

3.14 DIVIDENDS TAX: COLLECTIVE INVESTMENT SCHEME ADJUSTMENTS

[Key provisions: Section 25BA and 18A(1)]

I. Background

CIS retention of funds

A collective investment scheme ("CIS") is an investment vehicle that facilitates portfolio investments for investors (technically referred to as unit holders). For income tax purposes, a CIS is treated as a flow through entity in relation to amounts of a revenue nature. This treatment is subject to a condition that non-capital amounts received by the CIS must be distributed to the unit holders within twelve months after the date of receipt by the CIS. If the CIS does not distribute these amounts within the required 12-month period, the amounts are deemed to be received by the CIS. Retained amounts retain their character (i.e. interest is be taxed as ordinary revenue and dividends are generally exempt).

Islamic CIS finance

With the development of Islamic finance within South Africa, Shariá-compliant CISs have emerged. One pre-requisite of Islamic finance is the required forfeiture of interest and other impermissible income. In view of this pre-requisite, Sharia-compliant CISs are subject to agreements that prevent impermissible amounts from being distributed to unit holders. These CISs instead donate impermissible amounts to various public benefit organisations. The impermissible amounts typically stem from interest received or accrued as well as dividends arising from profits derived from interest.

II. Reasons for change

Retained dividend amounts

A CIS often retains a portion of the dividends and interest received in order to accommodate services payable to the associated management company. In the case of dividends, the amounts retained essentially act as a cession of the dividends to the CIS in exchange for services. This assignment is similar to the purchase of dividends commonly found in cessions, whereby the character of the dividend consideration should be viewed as transformed in ordinary revenue.

CIS Islamic donations of impermissible amounts

Although a CIS is entitled to deduct donations to public benefit organisations classified within Part II of the 9th Schedule like other taxpayers, the 10 per cent taxable income limit on deductible donations poses a practical problem. A CIS typically has little or no taxable income because taxable income is retained solely for management fees. This limit is especially problematic for Islamic finance CISs that regularly donate impermissible receipts or accruals.

III. Proposal

Retained non-capital amounts

It is proposed that all dividends be treated as ordinary income if retained by the CIS beyond the requisite 12-month period.

Example:

Facts: CIS holds 800 shares in Domestic Company XYZ. CIS has also independently borrowed 600 Domestic Company ABC shares from pension fund (i.e. the long and short positions have no transactional linkage to one another). On 15 July 2012, Domestic Company XYZ announces a dividend of R1 per share, and Domestic Company ABC announces a dividend of R1 per share. As a result, Domestic Company Shareholder receives R800 dividends from the XYZ shares held long and must pay R600 manufactured dividends in respect of the ABC shares held short. Both the XYZ and ABC shares are substantially similar with CIS using R600 of the XYZ dividends to pay the R600 owed in respect of the ABC shares held short.

***Result*:** The XYZ dividends retained by CIS to pay the manufactured dividends are treated as taxable ordinary revenue. It makes no difference whether the ABC and XYZ shares are substantially similar to one another.

CIS donations

The 10 per cent taxable income limit for deductible donations will not apply to a CIS. Instead, deductible donations by a CIS will be limited to 0.5 per cent of the weighted average annual value of net CIS assets during the year of assessment in which the donations occur.

IV. Effective date

The proposed amendment will be effective for CIS years of assessment commencing on or after 1 January 2012.

3.15 DIVIDENDS TAX: CONTRIBUTED TAX CAPITAL ADJUSTMENTS

[Key provisions: Section 1 ("contributed tax capital" definition); paragraph 19 of the Eighth Schedule]

I. Background

Dividends versus return of capital distributions

Company distributions (including buyouts and liquidations) can be classified as dividends or return of capital. As a general matter, the default position is dividend treatment. However, the transfer of contributed tax capital ("CTC") translates this treatment into a return of capital distribution.

Under the new dividends tax, dividends paid to individual and foreign persons are subject to a 10 per cent charge (with the latter potentially reduced by virtue of tax treaty). Dividends paid to domestic companies are tax-free. The dividends tax is largely enforced through a system of withholding imposed on the paying company (or regulated intermediary).

Return of capital creates different results. Gain from return of capital payments to individuals are generally subject to a 10 per cent charge, payments to domestic companies are subject to a 14 percent charge, and payments to foreign persons are largely exempt. Companies making return of capital distributions will be required to inform recipient shareholders so that these shareholders can properly account for the gain in respect of their annual returns.

Allocation of CTC

CTC is a company-level account (not a per share account). The decision to distribute CTC and allocate that CTC is made by the distributing company. However, return of capital distributions in respect of a class of shareholders must be allocated pro rata.

II. Reason for change

Questions exist about the nature of the rule requiring a pro rata allocation of CTC. Moreover, concerns continue to exist that taxpayers can artificially over-declare or under-declare CTC in order to manipulate the tax system, especially in regards to share-buy backs and company liquidations. The CTC allocation rules also do not envisage a situation where CTC is allocated to a single shareholder when only that shareholder amongst a class receives a special dividend.

These allocation concerns exist because of the differing impacts of the new Dividends tax and return of capital payments. Admittedly, domestic natural persons are largely indifferent because the Dividends tax and return of capital give rise to approximately the same 10 per cent charge. However, domestic company shareholders have an incentive to over-inflate dividends vis-à-vis return of capital payments because the former are wholly exempt. On the other hand, foreign shareholders have an incentive to over-inflate return of capital payments due to the untaxed nature of these payments in their hands.

III. Proposal

Buybacks and liquidations

Companies reacquiring their own shares (e.g. in a buyback or redemption) in respect of a disposal are deemed to transfer CTC. This transfer is deemed to be equal to the proportionate share of the CTC in relation to the class. All CTC is deemed to be transferred in the case of a deemed disposal resulting from a liquidation (triggered on the date of dissolution or deregistration or the date that the liquidator declares no reasonable grounds exist for further distributions to shareholders). This CTC transfer occurs on a pro rata basis in respect of each impacted class.

Furthermore, no capital loss should be allowed if that loss arises as a result of an exempt dividend being paid to a shareholder prior to a share buy-back, liquidation or similar transaction in which shareholders retire (or are deemed to retire) their own shares back to the issuing company. In order to achieve this result, all exempt dividends occurring two years before a buyback or liquidation (e.g.) will reduce the capital loss (not just extra-ordinary dividends).

Example 1:
Facts: Company Shareholder owns 50 ordinary shares in Company X with a base cost of R38 000. Company X has a total 250 ordinary shares outstanding. The CTC allocable to the class is equal to R400 000. Pursuant to a buyback, Company Shareholder surrenders all 50 of its ordinary shares in exchange for R100 000.

Result: Of the R100 000 distributed to Company Shareholder, CTC of R80 000 must be allocated to the retiring shares (1/5th of R400 000). The net result is a R80 000 capital distribution and a R20 000 dividend.

Example 2:
Facts: Company X is in liquidation and has 800 ordinary shares outstanding. Company Y holds 200 of these shares with an aggregate base cost of R380 000. The CTC allocable to the class is equal to an amount of R600 000. On date of dissolution, Company X has no assets to distribute to the shareholders.

Result: The dissolution triggers a deemed disposal with all CTC being transferred. The CTC allocable to Company Y is R150 000 (1/4th of R600 000), thereby resulting in a capital loss of R230 000 (R150 000 – R380 000). This loss is reduced to the extent Company Y received any exempt dividends within two years prior to the liquidation dissolution date.

Non-retiring distributions

As under current law, no requirement exists to allocate CTC to a non-retiring distribution (distributions other than buy backs or liquidations, etc…). However, if the paying company decides to transfer CTC pursuant to the distribution, the allocation of the CTC available in relation to that class will be clarified. Under the law as revised (and as initially intended), the distributing company will be limited in transferring CTC. In particular, the CTC allocable must "not exceed" the proportion of the shares generating the distribution in relation to the total shares in that class.

IV. Effective date

The proposed amendments will come into effect when the dividends tax comes into effective.

3.16 DIVIDENDS TAX: REMOVAL OF THE VALUE- EXTRACTION TAX (VET)

[Key provisions: repeal of proposed part IX (the VET)]

I. Background

The proposed Dividends Tax regime shifts the tax liability in respect of dividends from the distributing company to the beneficial owner of the dividend. As part of this change, the 'dividend' definition has undergone significant amendments. The new dividend definition encapsulates any amount that has been transferred or applied by virtue of any share held in that company. This definition accordingly seeks to move beyond pure dividends declared so as to cover at least some forms of disguised dividends.

In addition, the Value Extraction Tax is intended to replace the current deemed dividend rules associated with the soon-to-be replaced Secondary Tax Companies. The objective of the VET is to trigger a tax when any form of value is extracted from a company for the benefit of a shareholder (or connected person in relation to that shareholder). The VET covers several forms of disguised dividends, including disguised dividends resulting from the granting of financial assistance (i.e. discounted loans or advances) to a company shareholder.

II. Reasons for change

General considerations

The determination of whether a payment by a company to its shareholders constitutes a disguised dividend is essentially a question that entirely depends on the facts and circumstances. The shifting of value from a company without a dividend declaration could alternatively stem from some other originating link, such as salary to shareholder-employees, payment for an asset or use thereof, or as an indirect gift by a controlling shareholder.

The VET (like the former deemed dividend regime associated with the soon-to-be-replaced Secondary Tax on Companies) assumes certain forms of value extraction automatically result in a deemed dividend without regard to the facts and circumstances. For instance, when a company pays or settles debts of a third party creditor owed by an indebted shareholder, the automatic result is deemed dividend treatment when the value shift could, in fact, stem from some other cause. This automatic deemed dividend stands in contrast to certain aspects of the "dividend" definition, which assumes that the term "dividend" includes disguised dividends (i.e. by covering payments to shareholders "by virtue of" the underlying shares).

Financial assistance

Like other methods of company value extraction, financial assistance in the form of discounted loans to shareholders is problematic by virtue of the fact that a dividend is automatically deemed to arise. Current law again fails to recognise that a below market loan could represent some other form of consideration (such as disguised salary for shareholder-employees). The calculation is also not in sync with other financial assistance calculations (for instance, the calculation differs from the fringe benefit calculation for discounted loans to employees).

III. Proposal

Facts and circumstances linkage

It is proposed that the VET regime be completely deleted. The determination of whether value extracted from a company amounts to a dividend or stems from some other cause must be resolved solely by reliance on the facts and circumstances. Consistent with this change, some of the technical "linkage" language associated with the gross income definition will be adjusted to ensure consistency. Whether a value extraction form a company qualifies as a dividend, salary, payment for the purchase or use of an asset, amongst others, must be determined through reliance on the same legal connection (e.g. "in respect of" or "as consideration for").

Example:
Facts: Company is owned 100 per cent by Individual. At the instance of Individual, Company makes a zero-interest loan to Individual.

Result: The zero-rated loan is possible because Individual owns all the shares of Company, thereby being "in respect of" the shares held by Individual. The "in respect of' language goes beyond the "by virtue of" test (which would focus on the technical legal rights associated with separate shares as opposed to a focus on the shares as held by one party in an aggregate).

As part of this change, the impact of value extraction to a person in the form of a donation will be clarified. More specifically, if value is extracted from a company at the instance of a person as a donation to a third party, two transactions have effectively occurred. The value extraction from the company represents some form of constructive payment to that person, followed by a donation by that person to the third party.

Example:
Facts: Company X is owned 60 per cent by Individual A and 40 per cent by Individual B. At the instance of Individual A, Company X makes a cash payment of R10 000 to Son (of Individual A) that is received by Son as a donation.

Result: The R10 000 cash is being applied to Son by virtue of Individual A's shares in Company X and should accordingly be viewed as a dividend to Individual A. The R10 000 amount should then be viewed as a donation received by Son from Individual A.

Discounted loans or advances

Although financial assistance (discounted loans or advances) from a company to a shareholder is no longer automatically a deemed dividend, a deemed dividend could possibly arise depending on the facts and circumstances. In these circumstances, the question still arises as to how to quantify the amount.

The proposed legislation accordingly creates an annual charge that is roughly comparable to the discount loan rules involving disguised employee fringe benefits.

IV. Effective date

The proposed amendment will be effective on the same date as the new Dividends Tax enters force (i.e. distributions received or accrued on or after 1 April 2012).

3.17 DIVIDENDS TAX: REVISED TREATMENT OF CAPITAL DISTRIBUTIONS

[Key provisions: Paragraphs 76, 76A and 76B of the 8th Schedule]

I. Background

Dividends versus capital distributions

Dividends and capital distributions can be in the form of either cash or assets. A company declaring a dividend is liable to Secondary Tax on Companies (“STC”) at a rate of 10 per cent. The STC will be replaced with a Dividends Tax at shareholder level at a rate of 10 per cent as of 1 April 2012. Under the Dividends Tax system, amounts distributed are treated as a dividend except to the extent the distribution reduces contributed tax capital.

Capital distributions are subject to Capital Gains Tax (“CGT”) at the rate of 10, 14 or 20 per cent depending on whether the shareholder is an individual, company or trust. Gain subject to CGT is generally determined by comparing the capital distribution received or accrued against the applicable base cost of the shares.

Calculation of capital distribution gains

In the shareholder’s hands, a capital distribution can either result in (i) a reduction of pre-CGT base cost, (ii) an addition to proceeds, or (iii) proceeds from the part-disposal of the shares. This treatment largely depends on the date on which the capital distribution is received or accrued to a shareholder.

A capital distribution occurring after 1 October 2007 triggers a part disposal of the share with the distribution treated as proceeds. Part-disposal treatment effectively means that only part of the base cost can be applied against the capital distribution proceeds. If the capital distribution occurs before 1 October 2007 with the full disposal of the shares occurring after that date, part-disposal treatment will generally be deemed to arise on 1 July 2011.

Pre-CGT shares

Special rules are required for determining the base cost of pre-CGT effective date assets (i.e. assets held before 1 October 2001), including pre-effective date shares. The purpose of these effective date rules is to exclude capital gain arising before CGT was implemented. The value of these pre-CGT effective date assets is determined based on one of three methods (as determined by the taxpayer):

The market value method;
The time-apportionment method; and
The 20 per cent proceeds method.

Determination of which method applies (and how each method applies) can only be made upon disposal of the relevant asset. In the case of capital distributions involving pre-effective date shares, application of the valuation method applies only in respect of the part disposal; application of the valuation method for disposal of the remainder is only determined upon disposal of the remainder.

II. Reasons for change

Conceptually, dividends should encompass realised and unrealised undistributed profits. Capital distributions should merely represent a return of the capital (i.e. the return of capital contributions made by the shareholders). However, part-disposal treatment as currently formulated triggers capital gain on amounts that effectively include both realised and unrealised undistributed profits. The net effect is to over-tax capital distributions by only allocating a portion of base cost as an offset when the full base cost associated with the underlying share should be available.

While Government has always understood that return of capital treatment should allow for a full base cost offset, the calculations for pre-CGT effective date shares have always been problematic. Delayed calculation of base cost until disposal has meant that the entire base cost of pre-CGT shares is unknown when a capital distribution is involved.

III. Proposal

Revised treatment for capital distributions

The capital gain calculation for capital distributions will be re-aligned in accordance with the intended concept. Capital distribution proceeds will be allocated against the full base cost of the underlying share involved in the distribution. These capital distribution proceeds will be applied to reduce the base cost of the underlying shares with capital gain arising to the extent these proceeds exceed base cost. This rule will apply for capital distributions occurring on or after the effective date of this proposal.

Capital distributions in respect of pre-CGT assets

If a capital distribution involves a share acquired before the 1 October 2001, the valuation date rules will be slightly revised. For purposes of the valuation rules, the share will be deemed to be fully acquired as of the capital distribution date. The net results will be to create an expenditure going forward (adjusted for the lack of gain or loss in respect of the deemed sale - repurchase). No subsequent change of method will be allowed.

Special 1 July 2011 deeming rule

Under current law, capital distributions occurring before 1 October 2007 will trigger a part disposal on 1 July 2011 if the underlying share is not disposed of before the 1 July 2011 date. If the share is disposed of before the 1 July 2011, the capital distribution amount is added to the proceeds of the share disposal. The 1 July 2011 was provided when the part-disposal capital distribution rules were added to give pre-existing shareholders time to adjust their affairs. As a further relief measure, shareholders in these circumstances will now have the deemed capital distribution deferred until 1 January 2012. This extended deferral will allow these capital distributions to enjoy the benefits of the new regime (as opposed to part-disposal treatment).

IV. Effective date

The proposed amendment will be effective for capital distributions that are received or accrued on or after 1 April 2012 and for pre-1 October 2007 distributions to the extent the underlying share is not disposed of before 1 April 2012.

3.18 DIVIDENDS TAX: COLLATERAL DEFINITION ISSUES

[Key provisions: Section 1 definitions of "dividends";: "return of capital"; "foreign dividends"; "foreign return of capital"; "shares" and "equity shares"]

I. Background

South African and foreign companies may distribute cash or in specie assets to their shareholders. These distributions may constitute a dividend or a return of capital.

Dividends distributed by resident companies generally attract Secondary Tax on Companies ("STC") at company level at a flat rate of 10 per cent. The STC system is to be replaced with a Dividends Tax at shareholder level. Dividends distributions made by non-resident companies are referred to as "foreign dividends" and are included in gross income, subject to certain exemptions. Under the system as revised, taxable foreign dividends will become subject to roughly the same 10 per cent flat rate of taxation as domestic dividends.

Return of capital payments fall under a different system of tax than dividends. Return of capital payments are subject to the Capital Gains Tax. The same capital gain rules apply to both domestic and foreign return of capital payments. As a result of changes made in 2010, the main distinction from distributions constituting a dividend versus a return of capital is based on whether the distribution comes from "contributed tax capital." Distributions drawn for contributed tax capital qualify as a return of capital while distributions from other sources qualify as dividends.

II. Reasons for change

The new Dividends Tax and comprehensive changes to the Companies Act legislation have forced core definitions to be revisited. In 2010, new definitions for domestic and foreign dividends were enacted along with a new definition of equity shares.

While recent changes are fundamentally correct, the piecemeal nature of these changes creates incongruities and potential anomalies. The relationship of domestic and foreign distributions is also somewhat unclear. A streamlined set of definitions is accordingly required to leave a cleaner landscape.

III. Proposal

Overview

Three sets of definitions are proposed. Under the first set, payments from domestic companies by virtue of their shares will be treated either as dividends or return of capital. Under the second set, payments from foreign companies by virtue of their shares will be treated either as foreign dividends or foreign return of capital. The third set clarify the share and equity share definitions.

Domestic dividends and return of capital

Core aspects of the domestic dividend and return of capital definitions share the same trigger. Both sets of transactions arise from amounts transferred or applied by a domestic company by virtue of the company's issued shares or similar interests, regardless of whether the transfer or application arose by way distribution or the repurchase of the company's own shares. Both sets of transactions exclude the issue by a company of its own shares and general buybacks of a company's own shares (i.e. where the seller on the open market cannot readily identify the purchaser).

The one notable distinction between domestic dividends and that of a domestic return of capital payment relates to contributed tax capital. Return of capital payments must be drawn from the paying company's contributed tax capital (i.e. a tax account stemming from shareholder investment measured in tax terms). Another lesser distinction is that amounts "applied from" can trigger dividends (but not a return of capital).

Foreign dividends and return of capital

The foreign dividend definition was added in 2010. This definition essentially relies on the foreign income tax law characterisation of the payment to determine whether the payment (or application of funds) is a dividend or otherwise. If the foreign country from which the payor resides lacks an Income Tax deduction in this regard, the foreign company law characterisation will prevail.

It is proposed that the foreign dividend remain with the addition of a foreign return of capital definition. Like the foreign dividend definition, the status of a foreign payment (or application of funds) of a foreign return of capital depends upon foreign income taxation (or foreign company law characterisation if the country in which the payor resides lacks an income tax). The distinction between a foreign dividend and foreign return of capital similarly depends upon foreign law.

Share and equity share definitions

The term "shares" and "equity shares" is frequently used throughout the Income Tax Act. In 2010, the term "equity shares" was defined as "any share or similar interest that does not carry any right to participate beyond a specified amount in a distribution." The equity share definition is fundamentally correct but will be changed to include "similar equity interest" as opposed to "similar interests" to clarify that the definition cannot exclude debt. The extension of the definition is meant to cover equity interests, such as a member's interest in a close corporation or a co-operative or a carry any right to participate beyond a specified amount in a distribution." Comparable equity interest in a foreign company.

In addition, a "share" definition is proposed. This definition will mirror the "equity share" definition with one caveat. The "share" definition applies regardless of whether the share or similar interest "carries any right to participate beyond a specified amount in a distribution."

Collateral changes

The above terms are frequently used throughout the Income Tax Act. The above new or revised definitions have a ripple effect throughout the Income Tax Act requiring review. The use of the term "dividend" will be clarified as to whether use of the term is intended to cover domestic and foreign dividends or simply domestic dividends. The term "distribution" will similarly be clarified as to whether the term includes both dividends and return of capital and whether the term includes domestic and/or foreign payments.

The terms "equity shares" and shares is also being reviewed throughout the Income Tax Act to ensure appropriate use. The Income Tax Act also uses the term "share" to denote a proportionate interest in an entity or profits. To avoid confusion, the term share will be removed in this latter context and substituted with a more accurate description.

IV. Effective date

The proposed amendment in respect of dividends and return of capital will be effective for receipts or accruals arising on or after 1 April 2012. The change in share and share equity definitions should be effective for years of assessment commencing from 1 April 2012.

3.19 DIVIDENDS TAX: REORGANISATION MITIGATION

[Key provisions: Sections 44(10) and 46(5)]

I. Background

As indicated elsewhere, the Secondary Tax on Companies ("STC") will be converted into a Dividends Tax as of 1 April 2012. This change will have wide-ranging ramifications within the Income Tax Act.

II. Reasons for change

The reorganisation rollover rules override or otherwise adjust many provisions within the Income Tax Act, including provisions relating to dividends. Some of these reorganisation rollover rules eliminate or mitigate the impact of otherwise existing taxable dividends. These mitigation provisions will accordingly have to be modified in light of the pending conversion from the STC to the new Dividends Tax.

III. Proposal

The reorganisation rollover rules contain two overrides in respect of the STC. The first override is contained in the amalgamation rules; the second is contained in the unbundling rules.

A. Amalgamation override

Under current law, any non-share consideration received by the amalgamated company shareholders within an amalgamation potentially gives rise to a dividend. This dividend potentially triggers STC. The rules also provide a system for the CTC of the amalgamated company to be shifted to the resultant company.

It is now proposed that the non-share consideration received by the amalgamated company shareholders be treated as distribution that qualifies as either a dividend or return of capital (depending on whether the CTC of the amalgamated company is transferred in the distribution). Any amalgamated company CTC shifted to the resultant company must be reduced by any CTC reduction in the amalgamated company caused by a non-share return of capital distribution within an amalgamation.

B. Unbundling override

Under current law, the unbundling of a company is deemed not to be a dividend for STC purposes if part of an unbundling transaction. The net result is the elimination of the STC charge as well as any corresponding STC credits. The unbundling company is also freed from any tax charge associated with any gain or loss in the unbundled shares.

It is now proposed that an unbundling transaction should not give rise to the Dividends Tax, ordinary revenue or a return of capital in the hands of the unbundling company shareholders. The unbundling company is also freed from any tax charge associated with any gain or loss in the unbundled shares.

IV. Effective date

The proposed amendment will be effective on the same date as the new Dividends Tax enters force (i.e. distributions received or accrued on or after 1 April 2012).

3.20 DIVIDENDS TAX: NEW DISPENSATION FOR FOREIGN DIVIDENDS

[Key provision: Sections 10B]

I. Background

A. Taxation of dividends paid by domestic companies

Under current law, the Secondary Tax on Companies generally imposes tax at a rate of 10 per cent on companies declaring dividends. This system is to be replaced with the Dividends tax system. The Dividends Tax will be levied at shareholder-level at a rate of 10 per cent, with certain exemptions. The liability to withhold the Dividends Tax falls on the company paying the dividend; whereas, the primary liability for the tax falls on the beneficial owner of the dividend.

B. Taxation of dividends paid by foreign companies

Foreign dividends are not subject to the current Secondary Tax on Companies nor will foreign dividends be subject to the new Dividends Tax. Foreign dividends mainly fall outside these regimes (except for foreign dividends paid in respect of dual listed companies) because South Africa lacks the administrative jurisdiction to directly tax the foreign company paying the dividends, even if paid to a South African resident.

As a general rule, foreign dividends are included in the recipient's gross income and taxed at marginal rates (that is, 28 per cent for companies and up to 40 per cent for individuals). This form of taxation is subject to several exemptions, as follows: (i) the participation exemption, (ii) the previously taxed income exemption, and (iii) the dual-listed companies' exemption (the last of which will be deleted once the new Dividends Tax comes into effect). In addition, natural persons are entitled to a de minimis exemption of R3 700 on the aggregate of foreign dividends received or accrued during any year of assessment.

A rebate (i.e. a credit) for direct foreign taxes paid in respect of a foreign dividends is available as a measure to relieve double taxation. Interest expenditure that is incurred in earning foreign dividends is deductible in determining the taxable income of the taxpayer but these deductions are ring-fenced against the ordinary revenue associated with foreign dividends.

II. Reasons for change

At issue is the lack of parity between domestic and foreign dividends. As stated above, taxpayers face a maximum rate of 10 per cent when receiving domestic dividends; whereas, taxpayers face a maximum 28 or 40 per cent rate when receiving foreign dividends. This disparity is particularly apparent in the case of dual listed companies. Dividends from JSE listed shares in respect of a dual listed company will be subject to the maximum 10 per cent rate; whereas, dividends from shares listed on a foreign exchange in respect of the same company are subject to a maximum 28 per cent or 40 per cent rate.

III. Proposal

A. Overview

The proposed disparity of maximum rates between domestic and foreign dividends will be eliminated. However, foreign dividends cannot become part of the new Dividends Tax because South Africa does not have the administrative jurisdiction to generally impose a withholding tax on foreign companies paying a dividend. Therefore, foreign dividends will remain within normal income tax system (including the provisional tax and final year of assessment payments), but the marginal rate system will be adjusted so that the maximum rate does not exceed the maximum 10 per cent rate imposed on domestic dividends.

B. Revised system for taxing dividends

Foreign dividends will continue to be included in gross income as in prior years. Taxation of these dividends will also continue to be subject to the participation and previously taxed income exemptions. However, the annual R3 700 de minimis exemption for dividends received or accrued by natural persons will be dropped (because this form of de minimis exemption is lacking under the new Dividends Tax).

More importantly, residual foreign dividend amounts (that is, amounts not subject to the participation or the previously taxed income exemption) will be subject to a further partial exemption. The purpose of this partial exemption is to limit the tax on foreign dividends to the 10 per cent maximum. In particular, the ratio for the exemption of foreign dividends received by companies is 18/28 and 30/40 for foreign dividends received by natural persons (and trusts). This means that the inclusion will be at a ratio of 10/28 for companies and 10/40 for individuals (and trusts), thereby resulting in a net maximum rate of 10 per cent.

Dividends received by resident from a controlled foreign company will be subject to roughly the same exemptions as foreign dividends received from other foreign companies. The participation exemption and the automatic partial exemptions (30/40 or 18/28) automatically apply because a controlled foreign company is deemed to be a taxpayer. A separate previously taxed dividend exemption exists for controlled foreign companies because the exemption has to account for the fact that the dividends are ultimately included at the South African shareholder level (as opposed to the controlled foreign company level).

C. Rebates and deductions

The rebate (i.e. credit) for direct foreign taxes paid in respect of foreign dividends will remain. While these rebates only take into account taxable income (thereby excluding foreign dividends exempt by virtue of the participation and previously taxed income exemptions), these rebates will not be directly reduced by the partial income (30/40 or 18/28) reduction. However, these rebates will be subject to the worldwide foreign source-to-total income ratio, just like any other foreign rebates. The worldwide foreign source-total income ratio will achieve this result by excluding all exempt income, even the partial (30/40 or 18/28) exempt income, from the numerator with the denominator not being reduce for the partial (30/40 or 18/28) exempt income.

However, the current deduction system for expenses associated with foreign shares will be dropped. Henceforth, no deductions will be allowed for expenses incurred in relation to the acquisition of the foreign shares because no comparable deduction is allowed for expenses associated with domestic shares.

D. Examples

EXAMPLE 1:

Facts: Mr. M, a South African resident, pays taxes at a marginal rate of 40 per cent. Mr. M holds 2 per cent of the total equity shares and voting rights in Foreign Company (a company that does not qualify as a controlled foreign company). Foreign Company pays a dividend of R1.2 million to Mr. M, which are subject to foreign withholding taxes of 8 per cent (i.e. R96 000).

Result: The R1.2m dividend will be included in Mr M's gross income. The participation and previously taxed income exemptions do not apply. However, the dividend is exempt to a ratio of 30/40. Therefore, the amount includable in Mr M's taxable income in relation to the dividend is R300 000 ($1/4^{th}$ of R1.2 million). Assuming no other income, the South African tax on the foreign dividend is R120 000 (i.e. R300 000 x 40%) less the R96 000 of foreign tax rebates, thereby amounting to R24 000.

EXAMPLE 2:

Facts: South African Company owns all the participation rights in CFC, a foreign financial instrument holding company. CFC has previously taxed income of R5 million. CFC declares and pays a dividend of R9 million to South African Company. Foreign withholding tax amounts to R720 000 (i.e. 8 per cent) in respect of the dividend.

Result: South African Company is not entitled to the participation exemption in respect of the dividend because CFC is a foreign financial instrument holding company. However, South African Company is entitled to the previously taxed income exemption in respect of the R5 million, leaving R4 million. Of this R4 million amount, roughly R 1,428,571 will be included in taxable income after the partial exemption is applied (i.e. exemption ratio of 18/28). Before foreign tax credits are taken into account, the South African tax on the foreign dividend is R400 000 (i.e. 28% x R 1,428,571). This South African tax is reduced by proportional section 6quat credits of R320 000 (8 per cent of R4 million), leaving R80 000 of South African tax.

EXAMPLE 3:

Facts: The facts are the same as Example 2, except that the foreign dividends tax withholding rate is 15 per cent.

Result: As in Example 2, the South African tax on the foreign dividend is R400 000 (i.e. 28% x R 1,428,571). Initially, the foreign tax rebates associated with R4 million is R600 000 (15 per cent of R4 million). However, the worldwide tax formula will effectively reduce the percentage to a maximum 10 per cent for the year (South African tax of 28 per cent multiplied R1,428,571 dividend by R4 million).

IV. Effective date

In the case of individuals and trusts, the proposed amendment will be effective for years of assessment commencing on or after 1 March 2012. In the case of companies, the proposed amendment will be effective for years of assessment commencing on or after 1 April 2012.

3.21 DIVIDENDS TAX: DIVIDEND STRIPPING ADJUSTMENTS

[Key provisions: Section 22B; paragraphs 43A and 19 of the 8th Schedule]

I. Background

A. Pre-sale purchaser-funded dividends

Pending anti-avoidance rules exist that deem certain pre-sale dividends as ordinary revenue or capital gain proceeds when those dividends are associated with the disposal of target controlled (i.e. more than 50 per cent owned) company shares. These anti-avoidance rules apply only in respect of resident shareholders and resident target companies.

The anti-avoidance rules are aimed at situations where pre-sale dividends stem from purchaser funding. In these instances, the target controlled company to be disposed of typically borrows funds guaranteed or backed by the purchaser and uses the funds to distribute dividends to the selling shareholder (with the purchaser group ultimately repaying the loan). The effect of these pre-sale dividends is to reduce the explicit selling price of the target company shares. In tax terms, the result is a potentially tax-free dividend if the selling shareholder is a company with the tax-free dividend acting as an economic substitute for taxable sale proceeds. The anti-avoidance rules accordingly convert the tax-free dividends into ordinary revenue or capital gain proceeds (depending on whether the shares are capital or ordinary in nature).

B. Extra-ordinary dividends

An older set of anti-avoidance rules exist to prevent extra-ordinary dividend stripping that significantly devalues underlying shares before disposal. The concern in this circumstance is the distribution of extra-ordinary tax-free dividends in respect of shares (held as capital) followed by a capital loss upon disposal of the shares (with the loss stemming from the devaluation of the shares caused by the dividend). The anti-avoidance rules essentially eliminate the capital loss.

I. Reasons for change

The landscape for both domestic and foreign dividends will change dramatically in 2012 with both domestic and foreign dividends generally taxable at an effective rate of 10 per cent. Both domestic and foreign dividends will also have a revised set of exemptions.

With these changes, the anti-avoidance dividend stripping rules need to account for the revised landscape. More specifically, the rules need to account for cross-border dividends (dividends coming in and out of South Africa) in addition to the current limitations imposed solely on dividends between domestic companies. The anti-avoidance rules for extra-ordinary dividends additionally need to be re-aligned for the revised set of dividend exemptions.

II. Proposal

A. New coverage for cross-border dividends

As stated above, the existing anti-avoidance dividend stripping rules apply only in respect of domestic dividends distributed to domestic companies. It is proposed that the anti-avoidance provisions be extended to additionally cover (i) foreign company dividends to South African shareholders, and (ii) domestic company dividends to foreign company shareholders.

B. Revised tainted dividends involved in extra-ordinary dividends

The goal of the extra-ordinary dividend stripping rules is to target extra-ordinary exempt dividends followed by artificial losses on share disposals. The proposed rules clarify the law regarding the (exempt) dividend triggering event and update definitions to fully reflect the current landscape. (Note: This provision has little practical impact on foreign shareholders because foreign shareholders generally fall outside the capital gains system unless the shares relate to an immovable property company).

C. Note on tax rebates (credits) to prevent double taxation

If a taxpayer receives dividends already subject to the Dividends Tax, a rebate is available to reduce normal taxes or capital gains otherwise due (i.e. the same rebate as for the ordinary revenue treatment arising from non-at risk dividends and manufactured dividends).

IV. Effective date

This amendment is effective once the Dividends Tax goes into effect.

3.22 ANTI-AVOIDANCE: SUSPENSION OF INTRA-GROUP ROLLOVERS

[Key provision: section 45]

I. Background

Section 45 allows for rollover relief when assets are transferred between members of the same group of companies in exchange for the issue of intra-group shares or of intra-group debt. Unlike other reorganisations, this form of relief creates a market value tax cost in the newly issued shares or debt (as opposed to a rollover tax cost).

II. Reasons for change

Intra-group rollover relief was primarily intended to facilitate transfers amongst member companies historically operating together in a single group. When the reorganisation rules were being formulated, it was alleged that relief was required to facilitate recurring asset transfers between group companies funded by intra-group loan accounts.

History, however, has revealed a totally different story. Taxpayers that regularly undertake the transfer of trading stock between company members have generally preferred not to utilise the intra-group relief mechanism. These taxpayers have instead taken the position that upfront taxable treatment is easier to maintain from a tracking perspective than rollover treatment. Instead, intra-group relief has mainly been used to facilitate leveraged buyouts so that interest on the debt incurred can be used against target assets. Many of these buyouts involve significant debt that effectively eliminates the profits of the target business for many years to come. In some of these cases, intra-group relief is used to disguise indirect purchases of preference shares generating tax-free dividends (that economically replicate otherwise taxable interest). Some of these latter schemes were identified several years ago (as "funnel schemes").

III. Proposal

Given the above concerns, section 45 rollover relief will be wholly suspended for a period of approximately 18 months (but the de-grouping charge remains for pre-existing transfers). During this period, the continued need for this relief will be re-evaluated along with concerns relating to excessive debt.

IV. Effective date

The proposed amendment will apply in respect of any asset disposed of on or after [1 June] 2011 but before 1 January 2013.

3.23 ANTI-AVOIDANCE: DIVIDEND CESSIONS

[Key provision: section 6sex; proviso (ee) to section 10(1)(k)(i)]

I. Background

Domestic companies are subject to secondary tax on companies (STC) at 10 per cent when distributing dividends; these dividends are exempt from tax when received or accrued by shareholders. Once the new Dividends Tax is in place, the 10 per cent tax on dividends will no longer be borne by the company paying the dividend but by the eventual recipient. This new tax on dividends contains a number of exemptions (such as the exemption for dividends paid to domestic companies).

Parties often enter into cession contracts whereby a cedent transfers rights to a cessionary. These cessions include the cession of dividends otherwise associated with underlying shares. Cessions may occur when dividend rights are ceded before or after the declaration of dividends. Cessions of this nature are typically undertaken in exchange for consideration. These cessions are generally effective and the amounts ceded typically retain their character as dividends.

II. Reasons for change

As a general matter, taxpayers treat dividend cessions as a mere assignment of dividends from a cedent (e.g. the holder of shares initially entitled to the dividend) to a cessionary (i.e. the assignee). However, in many circumstances, the character of a ceded dividend is effectively transformed once the dividend is separated from any meaningful stake in the underlying shares. Stated differently, the cessionary is merely purchasing an income stream – an event that makes the receipt of the income distinct from the distribution of the underlying dividend.

At a theoretical level, two differing policies are at stake. Domestic companies receiving dividends are exempt to prevent multi-tier taxation. Distributed profits going through a chain of domestic companies should generally be taxed only once (under the STC, the charge typically arose at the beginning; under the new Dividends Tax, the charge will typically arise at the end). On the other hand, the progressivity principle demands that each taxpayer (including companies) be fully subject to tax at ordinary rates. While the progressivity principle should give way to the principle against multiple-level taxation as a general matter, this compromise becomes questionable when the company beneficiary of a dividend lacks any meaningful interest in the underlying shares giving rise to the dividend. In the case of a dividend cession, the cessionary receiving the dividend has no interest in the underlying shares and should accordingly be fully taxed under the progressivity principle.

The lack of balance outlined above has given rise to a host of avoidance schemes. Many companies regularly purchase dividends via cessions solely due to their tax-free nature so as to undermine the tax system. These purchases would simply not exist but for tax arbitrage. Dividend cessions occuring after dividend declaration especially lack any non-tax commercial rationale. Still worse, these cessions are often accompanied by seemingly deductible finance schemes, whereby the link between the tax-free income and the deductible finance is artificially broken. The net effect is a book tax disparity with taxpayers achieving neutrality on their financial books along with a net tax deduction.

III. Proposal

A. Overall concept

The policy around dividend exemptions is not at stake. Domestic and foreign companies (and trusts) receiving dividends will remain exempt (or subject to tax at a reduced rate) if these companies have a meaningful underlying stake in the company paying dividends. To be meaningful, the company (or trust) receiving the dividend must be exposed to the risk of profit and loss associated with the underlying share. Failure to achieve this meaningful interest will result in tax at ordinary rates.

The proposal will mainly eliminate the tax-free nature of dividends obtained by way of cession and for dividends in respect of shares held only momentarily. Dividends received shortly before the disposal of trading stock will also be subject to tax as ordinary revenue. These pre-sale dividends are effectively part of the sales trading stock proceeds,

B. Technical trigger

Proposed taxation of certain dividends at ordinary rates applies solely to domestic and foreign companies (or trusts) receiving (domestic or foreign) dividends. Natural persons fall outside this ordinary treatment because the disconnect between dividends received by natural persons and the underlying shares may be driven by other non-tax factors (e.g. testamentary trusts offering dividend streams to heirs without the heirs having any underlying interest in the underlying distributing shares).

Ordinary treatment under the proposal will arise under either one of two triggering events. The first trigger is an automatic trigger for dividends from all shares; the second trigger arises only if the underlying shares are held as trading stock.

Automatic Trigger: Ordinary revenue treatment (i.e. the loss of exemption) for dividends arises whenever a company benefiting from dividends fails to hold the underlying shares from the beginning of the date that the dividend was declared until the close of the date when the dividend is received and accrued. This rule applies without regard to whether the underlying shares are held as trading stock or as capital.

Trading Stock: Under this second trigger, ordinary revenue treatment additionally applies whenever a company benefiting from those dividends holds the underlying shares as trading stock and the dividend is received or accrued within 45 days before disposal of the share.

Note on offsetting positions: For purposes of the above timing calculation, taxpayers benefiting from dividends cannot take into account days whereby the taxpayer has offsetting positions in respect of the underlying distributing shares. For instance, if a taxpayer holds distributing shares in the long position and at the same time has in place a short position to hedge the risk in respect of those long shares, the holding in the long position will be disregarded for the duration of the hedge.

Example 1:
Facts: Distributing Domestic Company declares dividends on 10 March 2012 in respect of the Distributing Domestic Company shares. On 11 March 2012, Domestic Company X acquires R5 million of Distributing Domestic Company ordinary dividends by way of cession. Distributing Domestic Company pays the declared dividends on 2 April 2012.

Result: The dividends ceded to Domestic Company X are taxed as ordinary revenue. No exemption applies because the shares are never held by Domestic Company X on the relevant dates.

Example 2
Facts: Distributing Domestic Company declares dividends on 12 June 2012 in respect of its ordinary shares and pays those dividends on 10 July. Domestic Company Shareholder owns the ordinary shares from 5 July 2012 until 15 July 2012 and accordingly receives the 10 July dividends. Domestic Company Shareholder holds the shares as trading stock until disposal on 15 July 2012.

Result: The dividends received by Domestic Company Shareholder are taxed as ordinary revenue. No exemption applies because the underlying trading stock shares are not held for the requisite 45 day period before disposal.

Example 3
Facts: On 20 March 2012, Domestic Company Shareholder acquires Distributing Domestic Company ordinary shares for investment capital purposes. On 15 September 2014, Domestic Company Shareholder changes the investment intent in respect of the ordinary shares to trading stock. Dividends are declared in respect of the ordinary shares on 20 September and paid on 1 October 2012. On the 10 October 2012, Domestic Company Shareholder sells the ordinary shares.

Result: The dividends paid to Distributed Company Shareholder are treated as ordinary revenue. The dividends are not exempt because the dividends are received or accrued within 45 days before disposal (the fact that shares are held for over two years before is irrelevant).

Shares held via trusts

Dividends receives through trusts require special considerations because two levels are involved. The ultimate beneficiary has an interest in the trust, and the trust has an interest in the underlying distributing shares. In these circumstances, the company beneficiary must have a vested interest in the underlying shares through the trust that satisfies both anti-avoidance rules.

Example
Facts: Discretionary Trust acquired Domestic Distributing Company ordinary shares in 2010 for investment purposes. On 15 January 2014, Domestic Distributing Company pays dividends in respect of its ordinary shares. The Discretionary Trust allocates these dividends to Domestic Company Beneficiary.

Result: The dividends received by Domestic Company Beneficiary are taxed as ordinary revenue. No exemption applies because Domestic Company Beneficiary never holds a vested interest in the underlying ordinary shares.

Tax rebates (i.e. credits)

As outlined above, the newly proposed rules apply to three sets of dividends: (i) dividends between domestic companies, (ii) foreign dividends received or accrued by domestic companies, and (iii) domestic dividends received or accrued by foreign companies. The latter two scenarios require tax rebates (i.e. credits) to offset double taxation. In the second scenario (foreign dividends received domestic companies), foreign tax rebates are already available against any South African taxes otherwise due. At stake is the third scenario (domestic dividends received by foreign companies). In the third scenario, the dividends at issue may be subject to the Dividends Tax in addition to being taxed at ordinary rates under the normal tax. To the extent this situation arises, the foreign shareholder is eligible to receive rebates (credits) against the normal tax for Dividends Tax already paid.

Example:
Facts: Distributing Domestic Company declares dividends on 10 October 2012 in respect of its ordinary shares. On 11 October 2012, Foreign Company Shareholder acquires R4 million of Distributing Domestic Company dividends by way of cession. Distributing Domestic Company pays the declared dividends on 2 April 2012. These dividends are fully subject to the Dividends Tax (without any tax treaty reduction).

Result: The dividends ceded to Foreign Company Shareholder are taxed as ordinary revenue. No exemption applies because the shares are never held on the relevant dates. However, the normal tax on the dividends can be reduced for the Dividends Tax paid.

IV. Effective date

This amendment is effective once the Dividends Tax goes into effect

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3.24 ANTI-AVOIDANCE: DEBT WITHOUT SET MATURITY DATES

[Key provisions: Section 8g; definitions of “date of redemption”; “demand instrument” and term in section 24J]

I. Background

Interest is commonly payable or receivable in respect of debt instruments (or interest is implied through various mechanisms, such as a redemption feature). Specific rules exist that are used to calculate the inaccrual and accrual of interest per specific period. In essence, these rules require an interest calculation that is based on the present value all future income streams payable or receivable by transacting parties (technically referred to as the “yield to maturity” calculation). The duration of the “term” of the interest forms an important part of the “yield to maturity” calculation formula with the maturity date (i.e. date of redemption) acting as a key marker.

II. Reasons for change

A concern exists that taxpayers are distorting the interest calculation rules by manipulating the maturity date. Some debt instruments arguably fall outside the interest calculation when they simply lack a maturity date. Payments on some instruments contain a final maturity date with early contingency dates. These instruments distort the calculation because the tax system focuses on the final maturity date when in fact the contingencies will most probably be triggered before. Other instruments are payable on demand so that the maturity date can technically fall anywhere between initial issue and the date demand is actually made. The nature of all these instruments creates difficulties even when created primarily for commercial reasons.

III. Proposal

Overview

In view of the above, a specific set of rules will be added to cover all three instruments outlined: (i) debt without a maturity date (known as perpetual debt), (ii) debt instruments with uncertain maturity dates, and (iii) demand instruments. Perpetual debt will be removed from the debt instrument rules; whereas, special maturity date rules will be added for the other two instruments.

Perpetual debt

Perpetual debt (i.e. a debt instrument lacking a maturity date) is essentially equivalent to shares (and indeed financial accounting fully takes this form into debt as such). Payments in respect of perpetual debt will accordingly be treated as dividends for both the payor and payee. As a result, payments in respect of perpetual debt will no longer be deductible with the payment instead being potentially subject to the new Dividends Tax.

Debt instruments with uncertain maturity dates

As stated above, a debt instrument may have a final maturity date with one or more maturity dates that may trigger termination before the final maturity date. In these circumstances, the yield to maturity calculation for these debt instruments will be based on the date that the termination will most likely occur based on the balance of probabilities. In addition, rights to renew or extend will be taken into account to extent these rights will more likely than not be exercised based on the balance of probabilities. It should be noted that all of these dates may change over time as facts and circumstances deviate from initial premises (thereby requiring annual adjustments).

Demand instruments

Instruments payable on demand create total uncertainty because the final maturity date is essentially unknown. Therefore, for the sake of simplicity, the term of the instrument is deemed to last for a one year period (i.e. 365 days). Therefore, the “yield to maturity” calculation will be automatically determined solely with reference to the present value of the amounts payable and receivable for that one year period.

IV. Effective date

In terms of the "perpetual debt" amendment, the amendment will apply to all amounts incurred and accrued on or after 1 April 2012 (consistent with the effective date of the new Dividends Tax). The other amendments will be effective in respect of amounts incurred or accrued during years of assessment commencing on or after 1 January 2012.

3.25 ANTI-AVOIDANCE: THIRD-PARTY BACKED SHARES

[Key provision: Section 8EA]

I. Background

Debt versus shares

Debt and share instruments have a number of differences in their features and their consequences.

In commercial terms, debt represents a claim on a specified stream of cash flows. In its purest form, this claim in the form of interest is payable despite the financial performance of the debtor. Shares, on the other hand, represent a contingent claim by shareholders on dividends directly or indirectly based on company profits.

In tax terms, debt payments are typically deductible by the payor with the same payments being includible as income by the payee. With the advent of the new dividends tax, dividend payments in respect of shares are not deductible by the payor but are potentially subject to a 10 per cent charge falling on the payee.
Depending on the circumstances, a tax incentive may exist for taxpayer to attach a label to a debt or share instrument that differs from the underlying substance.

Legislative anti-avoidance rules

Setting aside the potential impact of commercial law, two sets of legislative tax rules exists that seek to address differences in respect of debt or share instruments when the label of those instruments differ from their substance. Stated dividends in respect of shares will be deemed to be interest if instruments labelled as shares contain certain debt features. Conversely, stated interest in respect of debt will not be deductible if instruments labelled as debt contain certain share features.

In the case of dividends, one set of rules exist that trigger interest treatment for stated dividends in respect of non-equity shares (i.e. certain preference shares) with a second set of rules existing for equity shares (typically ordinary shares). In terms of non-equity shares, puts, calls and related purchase/sale rights in respect of those shares will trigger interest treatment for the share yield if these rights are exercisable within three years. In terms of equity shares, puts, calls and related purchase/sale rights in respect of those shares will trigger interest treatment for the share yield if: (i) these rights are exercisable within three years, and (ii) the shares contain at least one key debt feature (such as a specified interest rate).

II. Reasons for change

A number of transactions have been identified involving the use of share issues (typically preference shares) to disguise otherwise taxable interest as tax-free dividend income. In these transactions, various types of shares are collateralised by third parties (i.e. parties other than the issuer) through put options, call options and other similar sale/purchase rights or commitments. For instance, if the issuer of shares is unable to pay the promised dividends, the holder of the shares may have a right to demand that a third party must acquire the shares. Alternatively, the same third parties may be funding, securing or utilising their credit rating as backing for the shares.

In essence, dividends in respect of shares backed by third parties raise the same concerns as dividend cessions. The shareholder lacks any meaningful stake in the issuer of the shares because the shareholder is ultimately looking to third parties for payment. It should be further noted that these shares would most likely be classified as debt for financial accounting purposes (with the overall arrangement often being utilised to erode the tax base).

III. Proposal

Ordinary treatment without timing requirements
In view of the above, stated dividends in respect of shares backed by third parties will be treated as ordinary revenue. This ordinary revenue treatment will cover various forms of third party backing, all of which will apply without regard to any three year or other timing requirements. More specifically, third party backing will be deemed to exist if:

The holder of the share has a fixed or contingent right to require any party (other than the issuer) to acquire the share or an obligation exists so that any of those parties is obligated to acquire the share;

The holder has a fixed or contingent right to procure, facilitate or assist with the acquisition of the share or repayment of the value associated with the share; or

The holder can rely on the guarantee or security of (or funding from) a party other than the issuer in respect of any payment attributable to the share, or the credit risk rating for the share is determined directly or indirectly with reference to parties other than the issuer.

Example 1:
Facts: Collective Investment Scheme holds preference shares issued by Special Purpose Company. The preference shares provide a yield slightly below money market interest rates. To guarantee the performance of the preference shares, a third party bank grants a put option to the collective investment scheme that is exercisable on the occurrence of certain credit events (e.g. failure of the preference shares to generate the specified level of interest).

Results: The dividends received by Collective Investment Scheme from the preference shares are to be treated as fully taxable ordinary income. This treatment exists because Collective Investment Scheme does not bear the risk of the issuer due to the put option.

Example 2:
Facts: Holding Company owns all the shares of Subsidiary 1 and Subsidiary 2 (the latter of which is newly formed). Subsidiary 1 transfers all of its assets to Subsidiary 2 in exchange for cash (supplied by a third party bank). Subsidiary 1 uses the cash to acquire preference shares generating a yield based on an interest rate factor. An obligation exists in respect of the preference shares that forces an offshore third party to purchaser the shares from Subsidiary 1 at a specified price.

Result: The dividends received by Subsidiary 1 from the preference shares are to be treated as fully taxable income. This treatment exists because again Subsidiary 1 does not bear the risk of the issuer due to the forced sale obligation.

Longer minimum periods for hybrid shares
As stated above, the current (share and debt) hybrid anti-avoidance rules are linked to a three-year time-frame. This three-year time frame requirement has allowed many parties to structure their instruments or arrangements so as to wholly circumvent the hybrid rules with ease (e.g. by making the instruments slightly longer than three years, such as three years and one day). Given the ease in which taxpayers are circumventing the three year rule, it is proposed that the three year rule be extended to ten years.

IV. Effective date

The proposed amendment applies to dividends received or accrued on or after 1 April 2012. However, in order not to disturb certain pre-existing arrangements, SARS will be given the authority, after consultation with the National Treasury, to treat pre-existing instruments as falling outside of the new regime if either: (i) the dividends are not directly or indirectly derived from financial instruments giving rise to a deduction, (ii) or are not directly or indirectly linked to any other transactions that do not otherwise erode the tax base. Taxpayers seeking this relief must apply for relief to SARS on or before 1 April 2012. The SARS secrecy provisions can be waived for this purpose.

3.26 ANTI-AVOIDANCE: DIVIDENDS IN RESPECT OF BORROWED SHARES

[Key provisions: provisos (ff) and (gg) to section 10(1)(k)(i) (ff)(gg)]

I. Background

Share lending is the practice of lending shares from an investor's portfolio to satisfy the temporary needs of another party (i.e. the borrower). The borrower typically sells the shares after the borrowing, thereby going short in respect of the share (i.e. thereby taking the risk that the shares will increase in value).

Share lending requires the borrower to keep the lender in a similar position even though the shares have been loaned. This parity is often achieved by having the borrower pay over to the lender "in lieu of" dividends arising in respect of borrowed shares during the lending period. These "in lieu of" amounts are known as manufactured dividends. Manufactured dividends are often deductible for the borrowing payor and treated as ordinary revenue for the lending payee.

II. Reasons for change

If a company holds identical shares in both long and short positions, the dividends in respect of both should leave the taxpayer economically neutral. The company is entitled to dividends on the one hand but must pay the same amount as manufactured dividends on the other. If both the long and short positions are linked, the dividends received or accrued are typically exempt and the manufactured dividends incurred are ineligible for deductions.

However, if the link between the long and short positions is broken, the taxpayer will still receive or accrue an exempt dividend while possibly being able to deduct the manufactured dividends incurred. Many schemes exist that serve to break this link with the taxpayer in a net tax loss position while leaving the taxpayer economically neutral. The lender in these schemes is typically an exempt party (e.g. an exempt pension fund or the exempt policyholder fund of a long-term insurer).

III. Proposal

The tax treatment of long and short positions in respect of dividends held in identical shares should be neutralised to the extent both positions offset each other. More specifically, if a (domestic or foreign) company taxpayer receives dividends in respect of (domestic or foreign) shares held, these dividends should be treated as taxable ordinary revenue to the extent any manufactured dividends are incurred in respect of identical shares borrowed. No factual connection is required between the long and short positions for this ordinary treatment to apply. In addition, any dividend in respect of borrowed shares will be treated as ordinary revenue Note: If a foreign company shareholder receives dividends already subject to the Dividends Tax, a rebate is available to reduce normal taxes otherwise due (i.e. the same rebate as for the ordinary revenue treatment arising from non-at risk dividends).

Example:
Facts: Domestic Company Shareholder holds 300 shares in Domestic Company XYZ. Domestic Company Shareholder has also independently borrowed 180 Domestic Company XYZ shares from pension fund (i.e. the long and short positions have no transactional linkage to one another). On 15 July 2012, Domestic Company XYZ announces a dividend of R2 per share. As a result, Domestic Company Shareholder receives R600 dividends from the XYZ shares held long and must pay R360 manufactured dividends in respect of the XYZ shares held short.

Result: Dividends received or accrued on the long position are not exempt to the extent any "in lieu of" dividends are incurred in respect of identical shares held in the short position. As a result, of the R600 dividends received or accrued in respect of the XYZ shares, R360 of these dividends are fully taxable as ordinary revenue.

IV. Effective date

This amendment is effective once the Dividends Tax goes into effect.

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4 INCOME TAX: INTERNATIONAL

4.1 REHAUL OF THE CONTROLLED FOREIGN COMPANY (CFC) REGIME

[Key provision: Section 9D]

I. Background

The CFC regime taxes certain income generated by South African CFCs on an accrual basis. More specifically, the CFC rules impose tax on South African residents in respect of their proportionate share of CFC tainted income.

A CFC is any foreign company in which South African residents own a more than 50 per cent interest in the profits or capital of the company or by means of voting rights. Tainted income consists of passive (or highly mobile) income as well as diversionary income. Passive income includes interest, dividends, royalties, rentals, annuities, exchange differences, insurance premiums, similar income and associated capital gains. Diversionary income generally includes income derived from suspect transactions between a CFC and a resident that will likely lead to transfer pricing concerns. Tainted (passive or diversionary) income is fully taxable in South Africa because CFC ownership of this income poses a high risk to the tax base.

The CFC attribution rules are subject to various exemptions, such as the foreign business establishment exemption, a de minimis exemption, a high-foreign tax exemption and related party exemptions. A further set of exemptions exist in respect of diversionary transactions that do not pose a risk to the tax base. From a policy perspective, all of these exemptions are part of a framework that seeks to strike a fair balance between protecting the tax base and the need for South African multinationals to be internationally competitive.

II. Reasons for change

The CFC regime is in its tenth year anniversary. While the regime closed many obvious loopholes, the ten year mark creates a useful opportunity for reflection based on practical experience. In the main, the CFC regime has largely closed the naked movement of passive income offshore and the naked use of shell companies to divert income offshore through unsustainable transfer pricing. Nonetheless, problems remain. The tainted income calculation is overly complex and creates uncertainties. For instance, the overly rigid nature of the regime triggers tainted income for non-tax driven commercial income and often allows taxpayers to artificially manipulate problematic income so as to avoid tainted treatment. Certain interpretations have also emerged that seemingly allow taxpayers to create a marginal nexus in respect of employment or activity to tax havens so as to claim exemption when the "supposedly" exempt income lacks any meaningful economic substance.

Other anomalies also give rise to persistent issues. Even though the definition of a CFC relating to control is largely effective and in line with international norms, certain taxpayers continue to use artificial constructs so as to defeat the CFC definition while retaining practical control of the foreign company. The CFC regime additionally contains certain elections and ruling mechanisms that add complexity with little benefit for the tax system.

III. Proposal

Overview

In view of the above, the core calculations associated with the tainted income calculation will be simplified. Certain tests will be more closely integrated with transfer pricing without current reliance on overly objective (and misdirected) criteria. Tainted income treatment of mobile income will also be segregated into discrete elements so as to be more closely aligned with the relevant issues of concern.

As a side matter, the proposed amendments address certain collateral issues associated with structural aspects of the CFC regime. These items include the closure of schemes to break control so as to avoid CFC treatment while retaining practical control, reduction of the threshold percentage for the participation exemption from 20 per cent to 10 per cent and removal of the rulings regime.

Overall, the current changes provide simplicity, certainty and strengthen the rules to guard against the possible erosion of the SA tax base. It is intended that these changes close structural deficiencies in the system and make the rules more targeted in line with the regime's underlying purpose without undermining the country's international competitiveness.

Income attributable to a foreign business establishment (FBE)

The current FBE exemption assumes that only the income relating to a substantive business can be "attributable to" a FBE. The amendment will highlight this assumption by expressly providing that income will only attributable to an FBE once arm's length transfer pricing principles are taken into account. In line with this proposal, attribution to a FBE must account for the functions performed, assets used and the various risks of the foreign business establishment. Mere connection of income to a FBE via legal agreements and similar artifices will not be sufficient. Indeed, this arm's length connection has always been the stated intention behind the "attributable" standard.

Simplification of the diversionary income determination

Under current law, three sets of diversionary rules exist. The first set of rules seeks to prevent the use of CFCs to shift income offshore when the import of goods is involved. The second set seeks to prevent the use of CFCs to shift income offshore when the export of goods is involved. The third set seeks to prevent the use of CFCs when the import of services is involved. Diversionary income is viewed as tainted CFC income even if attributable to an FBE.

The overly mechanical nature of the diversionary rules has caused problems for both legitimate commercial activities and for the meaningful protection of the fiscus. Non-tax motivated commercial activities often become trapped by the mechanical rules while the overly rigid nature of the rules allow for tax avoidance in the case of more flexible non-tax motivated activities. While the unintended commercial impact of these rules has been substantially mitigated with the introduction of the high-foreign tax exemption, the underlying concerns remain. In view of these concerns, the following changes are proposed:

Imported goods: The rigid mechanical nature of the diversionary rules in respect of imported goods from CFCs will be entirely removed. Instead, the imported goods diversionary rules will be triggered only if three (simplified) conditions exist:

Firstly, as envisioned under current law, a CFC must be disposing of goods directly to a connected South African resident as under existing law. In addition, the newly proposed regime will alternatively cover disposals indirectly made to these same connected South African residents. The indirect rule essentially seeks to capture a CFC's disposal of goods ultimately destined for import to a connected South African resident (thereby ending the practice of interposing shell companies so as to break the import link).

Secondly, the sales income of a CFC must be subject to a foreign rate of tax that falls below 50 per cent of the South African company rate (i.e. 14 per cent) after taking tax credits into account. In other words, the CFC must be located in a low-taxed jurisdiction.

Thirdly, the sales income must not be attributable to the activities of a permanent establishment (as defined in the O.E.C.D. Model Tax Treaty Convention) located in the CFC's country of residence. In other words, the CFC sale destined for South African import will be triggered if sales income is simply associated with various forms of "preparatory and auxiliary activities" or with activities outside the CFC's country of residence. Like the revised FBE test, the test of "attribution" will require a transfer pricing analysis.

Exported goods: The diversionary rules associated with South African exports to a CFC will be completely removed. The additional protection is not required because the value-adding activities largely occur on-shore – all of which make the task of enforcing arm's length transfer pricing principles more manageable.

Imported services: The diversionary rules associated with imported services will be revised in line with the revised rules for imported goods. More specifically, the performance of services by a CFC to a connected South African resident will trigger the diversionary rules only if both: (i) the CFC service income is subject to a rate of tax below 50 per cent of the South African company rate (after tax credits are taken into account), and (ii) the CFC service income is not attributable to a permanent establishment (using arm's length pricing principles) within the CFC's country of residence.

Removal of the transfer pricing penalty

Under current law, transfer pricing violations involving a CFC trigger tainted treatment for all amounts derived from the suspect transaction, not just the reallocation of misallocated income. This "all-or-nothing" rule is misdirected and will accordingly be deleted.

Mobile income

As a general rule (and consistent with current law), mobile income accruing to a CFC will be automatically taxable unless specific exemptions relevant to that income stream are applicable. As under current law, the FBE exemption will per se not apply even though the mobile income may be attributable to FBE activities. Unlike current law which mixes mobile income into one set of rules, the targeted mobile income will be covered under four broad but distinct categories – income from financial instruments, tangible rentals, intellectual property and insurance.

Financial instrument income

Income from financial instruments (e.g. debts, shares and derivatives) derived by a CFC will be taxable unless: (i) the CFC is a bank or credit provider, or (ii) the income is subject to the working capital exemption. Both exemptions exist under current law but are being streamlined more in line with initially intended principles.

Bank and credit provider exemption

In terms of the bank or credit provider exemption, mobile CFC income will not be tainted if the income is derived from the CFC's principal trading activities of a bank or credit provider unless those activities constitute treasury operations. All of these determinations rely on a facts and circumstances analysis.

However, notwithstanding the above facts and circumstances analysis, the mobile CFC income will be denied relief as a treasury operation if either:

The CFC fails to conduct more of its principal trading activities in its country of residence than any other country; or

The CFC does not regularly accept deposits, make loans, issue letters of credit, provide guarantees, or effect similar transactions with unconnected persons; or

The principal trading activities of CFC fail to be more than 50 per cent derived from activities associated with unconnected persons.

Working capital exemption

The working capital exemption will replace the current 10 per cent de minimize exemption. The working capital exemption will apply only if the tainted financial instrument income is associated with financial instrument receipts and accruals that do not exceed 5 per cent of total CFC receipts and accruals. It should be noted that the working capital de minimize exemption does not apply to other forms of mobile income because working capital is typically only held in the form of financial instruments.

South African deductible payment override

The aforementioned bank/credit provider and working capital exemptions will not apply in respect of financial instrument income is associated with a deduction from the same or an interdependent financial instrument. For example, if deductible interest is paid from a SA company to a CFC in respect of a debt instrument, the corresponding CFC interest income is tainted without regard to the bank/credit provider or working capital exceptions. This rule prevents tax mismatches when the globally connected parties are economically neutral.

Insurance income

Insurance premiums derived by a CFC will generally be taxable. However, an exception exists if the income is derived from the CFC's principal trading activities of an insurer unless the insurer is a captive. These tests are largely based on the facts and circumstances, but an insurer will always be deemed to be a captive if either:

CFC conducts more insurance business in its country of residence than in any other single country;
The CFC regularly accepts premiums or effects similar transactions for the account of unconnected persons; or
The CFC fails to derive more than 50 per cent of its income or gains from principal trading activities with unconnected persons.

Notwithstanding the above, insurance premiums received by a CFC will give rise to tainted treatment if received form a connected South African resident and deductible by that resident. As discussed above, this rule prevents tax mismatches when the globally connected parties are economically neutral.

Intellectual property (royalties and sales)

Royalties derived by a CFC will be taxable unless the CFC actively develops the intellectual property relating to that royalty. Once again, the exemption for foreign actively developed intellectual property will not apply if the intellectual property gives rise to a deductible payment from a connected South African resident.

CFC tainted treatment in respect of capital gains from intellectual property will be simplified. This form of property will be taxed largely in accordance with the rules relating to the FBE exemption, but intellectual property derived from South Africa is per se tainted.

Immovable (rentals and sales)

The rental derived by a CFC from the leasing of immovable property will be exempt from tainted mobile income treatment. The disposal of immovable property will be similarly eligible for the FBE exemption without deviation.

Tangible movables (rentals and sales)

The rental derived by a CFC from the leasing of movables will be fully taxable unless the lease is an operating lease (defined roughly in line with the ring-fencing rules for financial leasing). More specifically, the expression “operating lease” will be defined as a lease concluded by a lessor that is not a bank, financial services provider or insurer if:

The property can be hired by members of the general public for a period of not more than 12 months;

The cost of maintenance and repairs occasioned by normal wear and tear is borne by the lessor; and

The lessee does not assume liability for the loss or destruction of the property, except if the lessee has failed to take proper care.

As with many other items of income, the exemption will not apply if matched by a deduction from a connected South African resident. Capital gains from the disposal of the movable property will also continue to be entitled to the FBE exemption without deviation.

Closure of “control” avoidance through trust and other artifices

The definition of CFC will be extended to specifically cover certain foreign companies that are under the de facto control of South African residents. This additional criterion will apply in the alternative to the general CFC requirements.

De facto control will exist where the parent has the power to govern the financial and operating policies of a subsidiary in order to derive a benefit from its activities. This is a facts and circumstances case. Factors such as control over the distribution and reinvestment policies, annual business plans, corporate strategy, capital expenditure, raising finance, winding up of the entity, voting rights or the power to appoint or remove the board of directors will be taken into account on a case-by-case basis. This concept is derived from financial accounting principles.

If a foreign company becomes a CFC by virtue of de facto control, the tainted income will be attributed completely to the South African person having de facto control. If a South African group jointly has control SARS, will nominate the appropriate company for attribution.

Example:
Facts: Foreign Parent owns all the shares of South African Holding Company. South African Holding Company owns South African Subsidiary 1, 2 and 3. Each South African Subsidiary is a discretionary beneficiary of Foreign Trust that owns all the shares of Foreign Subsidiary, a special purpose vehicle. A tax haven charity is also a discretionary beneficiary of Foreign Trust. Through appointment of the trustees and through certain side agreements, the South African companies have de facto control over Foreign Subsidiary with Foreign Subsidiary being including with the consolidated statements headed by Foreign Parent.

Result: Even though Foreign Trust prevents formal indirect control by South African residents, this form of de facto control will trigger CFC treatment for Foreign Subsidiary due to the potential for accounting consolidation. The CFC tainted income will be attributed to South African Holding Company (as the South African parent of the group).

Miscellaneous

As part of the simplification, a number of miscellaneous provisions will be deleted and streamlined. These provisions are currently in such a form that the added complexity outweighs their potential existence.

Shift to a ten per cent threshold

The ownership thresholds in respect of the dividend and capital gain participation exemptions in relation to foreign shares will be reduced from 20 per cent down to 10 per cent. This lower threshold is consistent with the global economic concept of direct foreign investment. In view of this reduction, the election to be treated as a CFC for foreign companies between the 10 and 20 per cent range will be deleted.

Removal of rulings option

The CFC rules provide SARS with the authority to waive the potential taint caused certain of the current diversionary rules. In light of the overhaul of these provisions (including the removal of their rigidity), the CFC ruling system will be deleted as superfluous

IV. Effective date

The proposed amendments will apply to the net income of a controlled foreign company relating to the year of assessment beginning on or after 1 April 2012.

4.2 UNIFICATION OF THE SOURCE RULES

[Key provision: Sections 9]

I. Background

South African residents are taxed on the basis of their world-wide income with foreign sourced income eligible for tax rebates (credits) in respect of foreign tax proven to be payable. Non-residents are only subject to tax on the basis of income derived from sources within (or deemed to be within) South Africa.

The Income Tax Act does not comprehensively define the term “source”. The source of income is instead initially determined with reference to the common law. In terms of the common law (see CIR v Lever Brothers & Unilever Ltd (1946 AD), the determination of source generally involves the doctrine of originating cause involving the following two levels of analysis:

What is the originating cause of the income; and
What is the location of that originating cause?

In respect of some categories of income, the Income Tax Act contains deeming rules. These deeming rules create deemed South African source income in addition to South African source income under the common law. These deemed source rules cover interest, royalties and capital gains (amongst others). Foreign source income exists only once it is determined that the income is neither actual South African source under common law principles nor deemed South African source under income tax legislation.

II. Reasons for change

The current source rules give rise to uncertainty, thereby imposing additional costs in respect of cross-border activities with little or no benefit for the fiscus. Part of this uncertainty stems from differing interpretations about the application of common law. The statutory regime relating to source is also somewhat scattered throughout the Income Tax Act. All of these technical source issues make South Africa a less attractive regional holding company destination from a tax perspective and make South African cross-border investment more expensive (including South African investment into Africa).

On a policy level, the source rules must also be revisited in light of the paradigm shift in regards to the South African tax system that occurred ten years ago. More specifically, the core of the source principles was formulated when South Africa operated on a source-plus basis with little change occurring once South Africa moved to a residency-minus system. The growing South African tax treaty network also raises the need for re-examination of how the domestic source rules should apply to the residual list of countries lying outside the network.

III. Proposal

A. Overview

In order to remedy the above uncertainties and anomalies, a new uniform system of source is proposed. The new system will represent an amalgamation of the common law, pre-existing statutory law and tax treaty principles. The starting point for these uniform source rules will largely reflect tax treaty principles (with a few added built-in protections) so that the South African system is globally aligned. The common law will remain as a residual method for undefined categories of income.

In terms of format, the new uniform set of source rules will eliminate the concept of deemed source. South African sources of income will be fully defined; items of income falling outside these definitions will be treated as foreign source income. As under current law, foreign residents are subject to South African tax only in respect of South African source income. South African residents remain fully subject to worldwide tax but may be eligible for foreign tax credits in respect of foreign source income.

B. Source Categories

Dividends

Current law

Under current law, two new sets of definitions were recently added in respect of dividends – the definition of "dividend" (which mainly covers domestic dividends), and the definition of "foreign dividend" (which covers dividends from non-resident companies). The explicit source rules for dividends depend on the common law, which mainly focuses on the share register.

OECD model treaty principles

The source determination under OECD model treaty principles focuses solely on tax residence. Therefore, a dividend will be locally sourced if the distributing company is a resident. Residence is based on the country where that company was formed or established or where that company's effective management resides (subject to the "tie-breaker" rules).

Proposal

Source will be determined using OECD principles. The definition of "dividend" will be clarified solely to cover dividends from domestic resident companies with the "foreign dividend" definition solely covering dividends from foreign resident companies. In terms of source, an explicit rule will exist stating that "dividends" as defined will be viewed as South African source (with foreign dividends implicitly being viewed as foreign sourced). The "share register" concept of common law will no longer be relevant.

Interest

Current law

The current source rules for interest are determined through a combination of common law and deeming legislation. The common law rules follow the doctrine of originating cause. The originating cause for interest is viewed as the supply of credit and the location of the originating cause is the place where that credit is supplied. Therefore, interest is sourced in South Africa if credit is provided in South Africa (typically by a South African credit provider). In addition, the legislative rules deem interest to be sourced in South Africa if the interest is derived from the utilisation or application of funds within South Africa. South African residents paying interest are presumed to be utilising or applying funds within South Africa.

OECD model tax treaty principles

OECD model tax treaty principles focuses on the tax residence of the payor (i.e. the debtor incurring the interest). However, if payment arises from (i.e. has an economic connection to) a permanent establishment located in the source country, the focus shifts to the source country.

Proposal

The source of interest will be determined using largely OECD principles.

The determination of source of interest will now be based on a two-part test, namely (i) the residence of the debtor paying/incurring the interest, or (ii) the place in which the loan funds are utilisation or applied. Therefore, interest will be sourced in South Africa if (i) paid by a South African resident, or (ii) if the interest is derived from use or application in South Africa (e.g. from a South African permanent establishment). The proposal removes any current law focus on the credit provider.

Moreover, the pending 10 per cent interest withholding regime to be applied in respect of payments to certain non-resident persons will be clarified. As clarified, the regime will apply only to South African sourced interest paid or payable to non-resident persons.

Royalties

Current Law

The current source rules for royalties are determined through a combination of common law and deeming legislation. The common law doctrine of originating cause for determining the source of royalties focuses on where the intellectual property producing the royalty was created, devised or developed. In addition, legislation deems royalties to be South African sourced if the royalties relate to the use, right of use or the grant of permission to use the intellectual property within South Africa. For purposes of 12 per cent royalty withholding, South African source royalties includes closely-related imparting of knowledge, assistance or services.

OECD model tax treaty principles

The OECD model tax treaty principles follow the principles used for interest. Once again, source will be based on the tax residence of the party paying the royalties or on royalties having an economic link with a permanent establishment.

Proposal

The determination of source in respect of royalties will again largely follow OECD tax treaty principles. Firstly, source will be based on the residence of the party paying the royalties. In addition, South African source royalties will exist if the royalties relate to the use, right of use or grant of permission to use intellectual property within South Africa. The proposal removes any focus on the party creating, devising or developing intellectual property (thereby removing the current disincentive to generate intellectual property within South Africa).

Private sector services

Current Law

The source determination for services is based solely on the common law. This source determination largely focuses on the place where the services are rendered (with some minority arguments in favour of the dominant activity giving rise to those services). If services are rendered partly within and partly outside South Africa, the allocation of source is based entirely on the facts and circumstances (e.g. time and value addition).

OECD model tax treaty principles

The OECD model tax treaty principles roughly follow the same principles as South African law and accordingly focus on the location where the services are performed. Moreover, if services are rendered partly within and partly outside South Africa, the allocation of source is based entirely on the facts and circumstances.

c. Proposal

The test for determining the source of service income will retain the same focus on where the services are rendered (with that focus being the sole focus enshrined into legislation). In addition, these newly legislated source rules will create a statutory allocation rules. More specifically, if services are rendered partly within South Africa and partly outside South Africa, the source for these services will be apportioned based solely on the time spent performing within South African as opposed to time spent abroad.

Related annuities and pensions

The proposed rules for determining the source of pensions or annuities derived from services will follow exactly the same principles as the source determination for service income. More specifically, the source for these annuity and pension payments will be based on the source of the underlying services giving rise to those payments. Therefore, if the underlying services are rendered within South Africa, the associated annuities and pensions will be viewed as South African source. If the annuities and pensions relate to mixed services (i.e. services rendered within and without South Africa), the allocation will be based on time spent.

Government services and associated annuities/pensions

Much like current law, the source of services for (or on behalf of) the various tiers of government will be deemed to be South African sourced without regard to where those services were rendered. Pensions and annuities will be treated similarly. This rule will cover Government in a broad sense (the national, provincial and municipal spheres, the holding of any public office as well as any entity falling within the PFMA or the MFMA).

Capital gains

The current deeming rules for determining the source of capital gains in respect of immovable and movable property follow OECD model tax treaty principles. A capital gain in respect of immovable property is sourced in South Africa if the immovable property is situated in South Africa. Special look-through rules apply if ownership exists through company shares and 80 per cent or more of the market value of the company shares stems from the immovable property. The source determination for capital gains in respect of movable property is based on the residence of the person disposes of such property (i.e. if the party disposing of the property is a South African resident, the disposal will be deemed to be South African sourced).

In view of their alignment with OECD model tax treaty principles, the current legislative source rules will essentially remain. However, the notion of deemed source will be eliminated, leaving the legislative determination as the sole determination.

Residual

The doctrine of originating cause (initiated in CIR v Lever Brothers & Unilever Ltd (1946 AD)) will be incorporated into legislation as a residual category. In other words, this doctrine will remain in respect of any residual item of income falling outside the main categories described above (e.g. rental income, insurance premium and trading stock profits).

Foreign

Items of income that fall outside the South African sourced categories listed above will be explicitly treated as foreign source income. As under current law, foreign persons will not be subject to tax in respect of foreign source income. Also as under current law, South African residents will be subject to tax on a worldwide basis but only foreign source income will generally be eligible for foreign tax credits.

IV. Effective date

The proposed amendment will apply to receipts and accruals in respect of years of assessment commencing on or after 1 January 2012.

4.3 SPECIAL FOREIGN TAX CREDIT FOR MANAGEMENT FEES

[Key provision: Section 6quin]

I. Background

South African residents are taxed on their worldwide income. However, South African residents are entitled to a tax rebate (i.e. credit) against normal South African tax in respect foreign taxes proven to be payable. Amongst other requirements, these credits are conditioned on the foreign taxes being applied to foreign sourced income. In other words, no foreign tax credits are available in respect of South African sourced income.

II. Reasons for change

A number of African jurisdictions impose withholding taxes in respect of services (especially management services) rendered abroad if funded by payments from their home jurisdictions. These withholding taxes are sometimes even imposed when tax treaties suggest that the practice should be otherwise. African imposition of these withholding taxes in respect of South African sourced services is no exception.

The net result of these African withholding taxes is double taxation with little relief. The South African tax system does not provide credits in respect of these foreign withholding taxes because of these taxes lack of a proper foreign source nexus. Only partial relief is afforded through the allowance of a deduction. While the South African position is theoretically correct, the practical implication of this position is adverse to South Africa's objective of becoming a regional financial centre. As long as this theoretically correct position is maintained, the only viable solution for regional operations is to shift their management location to a low-taxed or no-taxed location so as to avoid double taxation.

III. Proposal

In view of the above, it is proposed that a new limited foreign tax credit be introduced. The scope of this foreign credit will be limited solely to foreign withholding taxes imposed in respect of services rendered in South Africa. These tax credits will be limited solely to South African taxes otherwise imposed on the same service income after taking applicable deductions into account. Foreign withholding taxes in excess of the South African tax cannot be carried over (i.e. the excess is lost). Given the introduction of this new foreign tax credit, the current deduction for non-creditable foreign taxes will be withdrawn as ineffective.

IV. Effective date

The proposed amendment will come into effect in respect of foreign withholding taxes paid in respect of years of assessment commencing on or after 1 January 2012.

4.4 CFC RESTRUCTURING

[Key provisions: Sections 42(1) 44(1), 46(1) and 47(1)]

I. Background

Resident companies can restructure their affairs through various transactions falling within the reorganisation rollover rules. Rollover relief means that the transactions themselves are exempt, but any gain is deferred until a later disposal. These rollover transactions can take the form of asset-for-share transactions, amalgamations, intra-group transfers, unbundlings and liquidations. This relief is premised on the fact that the parties at issue have merely transformed their interests in the underlying assets as opposed to a cash-out of underlying risks. These relief measures are not available to the restructuring of foreign operations (except in very limited circumstances).

A simpler and narrower set of parallel relief provisions exist for offshore restructurings, known as the capital gains participation exemption. Under this exemption, gain is wholly exempt (not simply deferred) when residents and CFCs dispose of equity shares in a 20 per cent held foreign company. However, this exemption is generally available only if the foreign shares are transferred to a totally independent foreign resident or to a CFC under the same South African group of companies. The restructuring of CFC assets can also qualify for tax relief if disposed of within the confines of the foreign business establishment exemption or if the disposal occurs within a high-taxed country.

II. Reasons for change

Many South African multinationals seek to restructure their offshore operations. These restructurings often occur when multinationals acquire foreign companies with inconveniently located subsidiaries and seek to move these foreign subsidiaries into more efficient locations within the group. In light of the current economic downturn, these restructurings have accelerated in order to realise economies of scale and to increase internal efficiency, thereby keeping South African multinationals globally competitive.

The current participation exemption applicable to offshore restructurings has a number of shortcomings. On the one hand, the regime is too narrow – allowing some restructurings while inadvertently excluding others (e.g. certain transactions lacking an actual disposal of shares or certain transfers to South African companies within the same group). On the other hand, the breadth of the exemption poses a risk to the tax base with some taxpayers entering into an internal restructuring solely to elevate the base cost of their shares, followed by a taxable sale with artificially reduced gain (due to the elevated base cost). A balance must therefore be struck between facilitating restructurings and preventing tax avoidance.

III. Proposal

Overview

In view of the above, the domestic corporate restructuring rollover rules will be extended to fully include the restructuring of offshore companies that remain under the control of the same South African group of companies. More specifically, the asset-for share, amalgamation, unbundling and liquidation rules will be revised to cover offshore restructurings within this framework.

It should be noted that the extension of the reorganisation rollover rules to cover foreign restructurings was always intended, but this extension was delayed until many issues involving offshore CFCs could be resolved and simplified. For instance, the initial system of indirect credits has been dropped and a simplified exclusion exists for high-taxed foreign country income.

In light of the extended deferral regime, the need for the participation exemption in respect of CFC restructurings falls away. The participation exemption for transfers to CFCs will accordingly be deleted in order to remove the possibility of avoidance.

Extension of the reorganisation rollover regime

Asset for share transaction:

Asset-for-share relief is currently limited to the transfer of any assets between residents and the transfer from a non-resident to a resident. This relief will now be extended to cover the transfer of foreign company equity shares to CFCs (thereby allowing intra-group foreign share-for-share transactions). In particular, this extended rollover relief will be extended to allow for the transfer of foreign equity shares (in addition to other pre-existing requirements for asset-for-share transfers) if:

the transferee constitutes a controlled foreign company after the disposal, and
both the transferor and transferee form part of the same group of companies under section 41 (with CFCs viewed as part of the group for this purpose despite their foreign status).

Both the transferee CFC requirement and the group requirement must be maintained for 18 months after the reorganisation, failing which gain will be triggered for the transferor.

Example 1:
Facts: South African Parent owns 10 per cent of the shares of Foreign Company (FC) and all the shares of CFC. South African Parent transfers all the shares of FC to CFC in exchange for additional CFC shares issued by CFC.

Result: The foreign share-for-share rollover relief will apply to the South African Parent. However, gain will be triggered if CFC status or group status is lost within 18 months.

Example 2:
Facts: Foreign Parent owns all the shares of South African Holding Company and Foreign Holding Company. South African Holding Company owns all the shares of CFC and 45 per cent of the shares of Foreign Company (FC). Foreign Holding Company owns the other 55 per cent of the shares of FC. South African Holding Company transfers all of its shares in CFC to FC. As a result of the transfer, FC issues additional shares to South African Holding Company, leaving South African Holding Company with 70 per cent in FC.

Result:
The foreign share-for-share rollover relief will apply because FC became a CFC immediately after the disposal and becomes part of the same group. However, gain will be triggered if CFC status or group status is lost within 18 months.

Amalgamation transaction:

The current amalgamation rollover relief is only available if the resultant company is a resident. Thus, a resident company can be merged into another resident company or a foreign company can be merged inbound into a resident company. This rule will be extended to cover the amalgamation, merger or conversion of a foreign company into certain resultant foreign companies. As in the current rules, the amalgamated foreign company must transfer all of its assets (other than assets used to settle debts incurred in the ordinary course of business).

Like the foreign share-for-share rules added above, this extended rollover relief for foreign amalgamations applies (in addition to other pre-existing requirements for asset-for-share transfers) if:

the resultant company constitutes a controlled foreign company after the disposal, and the amalgamated company and the resultant company form part of the same group of companies under section 41 (with CFCs viewed as part of the group for this purpose despite their foreign status).

Like the current rules, the resultant company does not have to issue shares in exchange for the assets of the amalgamated company (note: many related party foreign amalgamations do not involve any transfer of shares).

Example:
Facts: South African Parent company owns all the shares of CFC 1, which in turn owns all the shares of CFC 2 and CFC 3. CFC 2 transfers all its assets to CFC 3. Following the transfer, CFC2's existence is terminated in terms of foreign law. CFC 3 does not issue any shares to CFC 2 (because CFC 2 already owns all of the CFC 3 shares).

Result: The amalgamation of CFC2 into CFC3 will qualify for rollover relief. CFC 3 is part of the same group of company as CFC 1 (once the CFCs are taken into account).

Unbundling transaction:

The current unbundling rules already allows for the unbundling of foreign companies. This relief, however, is limited to situations involving 95 per cent ownership.
The unbundling of foreign companies will be aligned to the newly revised rules. More specifically, this extended rollover relief will allow for the unbundling foreign holding companies (in addition to other pre-existing requirements for asset-for-share transfers) if:

the unbundled company constitutes a controlled foreign company after the disposal, and

the unbundling company and unbundled company form part of the same group of companies under section 41 (with CFCs viewed as part of the group for this purpose despite their foreign status).

Liquidation transaction:

The current liquidation rollover relief covers the liquidation of companies into domestic holding companies as well as liquidations into certain foreign holding companies. The liquidation of foreign companies will be aligned to the newly revised rules. More specifically, this extended rollover relief will allow for the liquidation into foreign holding companies (in addition to other pre-existing requirements for asset-for-share transfers) if:

the transferee holding company constitutes a controlled foreign company after the disposal, and

both the liquidating company and transferee form part of the same group of companies under section 41 (with CFCs viewed as part of the group for this purpose despite their foreign status).

Participation exemption:

The capital gains tax participation exemption will be limited to the transfer of equity shares to totally independent foreign residents. Transfers to CFCs will now be excluded as these transfers are covered by the reorganisation rules.

IV. Effective date

In the case of the reorganisation rules, the proposed amendments will apply in respect of transactions entered into on or after 1 January 2012. In the case of the participation exemption, the proposed amendments will apply in respect of disposals entered into on or after 1 January 2012.

4.5 OFFSHORE CELL COMPANIES

[Applicable provisions: Section 9D,"foreign company" and "cell protected company" definitions]

I. Background

Taxation of offshore operations

South African residents are subject to tax on a worldwide basis (i.e. foreign activities of a South African resident are fully within the South African tax net). In addition, South African tax indirectly applies to tainted activities conducted by controlled foreign companies (CFCs). Control of a foreign company generally exists if South African residents own more than 50 per cent of the participation and voting rights of the foreign company. CFC activities subject to indirect taxation mainly include passive income (e.g. interest and royalties) and diversionary income (i.e. income readily susceptible to transfer pricing manipulation).

CFCs engaged in business as an insurer may or may not be subject to indirect taxation. If a CFC generates most of its revenue from independent customers, no indirect taxation applies. On the other hand, captive foreign insurers (i.e. foreign subsidiaries largely earning premiums from fellow group companies) are fully subject to indirect taxation because their accumulated profits essentially represent passive reserves for the group. As a result, the tax law places CFC captive insurers on par with domestic captives – full taxation with a deduction for premiums set aside for reserves to be paid in fairly short order.

Roll of foreign statutory cell companies

Foreign statutory cell companies (technically, often referred to as "protected cell companies" or "segregated account companies") effectively operate as multiple limited liability companies, separated into legally distinct cells. These cell companies are often found in the jurisdictions of Bermuda, Guernsey, Gibraltar, Isle of Man, Jersey, Vermont, Mauritius and Seychelles. The cell company is a single legal entity that operates in two distinct parts. These parts are the core and the other cells. There is only one core, but there may be an infinite number of other cells. The core is owned by the founding members of the company who are the service providers and central managers of the company as a whole. The other cells are designed to isolate risk for their "customer" users. Cell companies normally issue two classes of shares namely: (i) ordinary voting shares issued to the practical owners of the core, and (ii) non-voting preference shares issued to the "customers" using the other cells (with a separate class of preference shares issued to each set of owners of each separate cell).

In the case of cell company insurers, each of the other (non-core) cells is funded by the insured's own capital contributions and premiums collected. The insured cell participant can only collect payouts via the insurance agreement and typically can only receive distributions upon termination of the cell's functions. Cells operate under a limited liability principle with each cell having full limited liability protection against the other cells (i.e. the creditors of the other cells cannot make claims against the cell). However, the core can be subject to the claims of other cells in limited circumstances.

II. Reasons for change

While it is undisputed that offshore cell captives often have legitimate non-tax commercial uses, these cells essentially operate as offshore captive insurers. Offshore captive insurers are generally subject to indirect tax under the CFC regime because the excess build-up of reserves is essentially passive income. No reason exists to allow offshore cell companies to be treated differently. Hence, as a matter of parity, offshore cells should fall with the South African CFC regime.

The other issue of parity is between domestic cell companies (governed by contract) and foreign cell companies. Both cell companies essentially provide the same functions and almost the same level of limited liability. Yet, lack of CFC treatment for each offshore cell provides these offshores cells with significant tax advantages over domestic cells.

III. Proposal

In view of the above, it is proposed that the CFC rules be adjusted so that each cell of a foreign statutory cell company will be treated as a separate stand-alone foreign company for all section 9D purposes. Therefore, if one or more South African residents hold more than 50 per cent of the participation rights in an offshore cell, the cell will be deemed to be a CFC without regard to ownership in the other cells. CFC treatment for the cell then triggers indirect tax for the participant cell owners to the extent the cell generates tainted income.

For purposes of the above rule, a cell exists if the cell is part of a legal entity formed, established (or converted) under foreign law, whereby the foreign law forming, establishing (or creating the entity by way of conversion):

segregates the assets of the entity into cells that are structurally independent; and

does not allow for claims to be made against the legal entity as a whole unrelated to cellular assets to be made against the cell merely because the legal entity as a whole is liable or obligated to satisfy those liabilities or obligations.

Example 1:

Facts: A protected cell company (PCC) located in Foreign Country X with the core managed and controlled by Country X's residents. The PCC has 100 cells; one cell (Cell 1) is owned by South African Company. The PCC is engaged in the business of insurance with each cell offering a different insurance package to each cell participant. Cell 1 provides insurance solely to South African Company (and some of its group members).

Result: The CFC status of Cell 1 will be tested separately. Because South African Company completely owns the cell, the cell qualifies as a CFC. The proportionate tainted amount of the net income of the cell will be attributed to the South African Company. All passive income will be tainted because the cell standing alone qualifies as a foreign financial instrument holding company (due to the connected person nature of the insurer parties). However Cell 1 may be entitled to deductions for short-term as a short-term insurer (i.e. section 28).

IV. Effective Date

The proposed amendment will apply in respect of foreign tax years of a CFC ending during years of assessment commencing on or after 1 January 2012.

4.6 TRANSFER PRICING: CORRELATIVE ADJUSTMENTS

[Key provision: Section 31]

I. Background

Transfer pricing anti-avoidance rules

The transfer pricing anti-avoidance rules apply arm's length principles to transactions, operations or schemes that have been entered into between connected persons with such terms and conditions that would not have been entered into between independent persons. The 2010 legislative amendments introduced certain modernisation changes to these transfer pricing rules in accordance with the OECD guidelines. The new wording of the section also removes certain previous uncertainties.

Deemed dividends

Under current law, deemed dividend rules exist as a measure targeted at minimizing the avoidance of the Secondary tax on Companies through the transfer of certain benefits to a company's shareholders without a formal declaration of a dividend. These deemed dividend rules contain a provision relating to transfer pricing. More specifically, a deemed dividend arises from any additional income (or reduced loss) of a South African company stemming from a transfer pricing adjustment. The purpose of this deemed dividend provision is to account for the removal of value from a South African company due to the underlying transfer pricing violation.

Reason for change

The automatic deemed dividend rules stemming from a transfer pricing adjustment will not be carried over into the new Dividends Tax regime. The deemed dividend rules under current law essentially seek to replicate the concept of secondary adjustments that exist in many transfer pricing regimes. Under current law, the transfer pricing rules provides SARS with a discretionary power to adjust the consideration to reflect an arm's length transaction if required. While this power provides SARS with the power to mark-up or mark-down the price or value associated with all the parties involved in a transfer pricing avoidance transaction, this power does not include the power to make secondary adjustments.

Appropriate use of this power, however, does not necessarily mean that a secondary adjustment should give rise to a constructive distribution. Secondary adjustments may represent other methods of value withdrawal (such as a constructive contribution). Hence, replication of the automatic deemed dividend rules into the new Dividends Tax would go too far in the other direction.

II. Proposal

Power to make secondary adjustments

It is proposed that the law be extended to cater for secondary adjustments arising from transfer pricing transactions. The OECD defines a correlative adjustment as - an adjustment that creates an increase or decrease on the tax imposed on one member of a group of companies, correlating to the primary adjustment made in respect of another member of the same group. A new provision will specifically be added to provide SARS with the discretionary power to evaluate consequential secondary adjustments on a facts and circumstances basis (including the power to create a deemed dividend).

Example:
Facts**:** Foreign Parent grants a R1 million loan to South African Subsidiary. Foreign Parent charges interest at a rate of 10 per cent, whereas the market related interest rate is 6 per cent. South African Subsidiary claims an interest deduction of R100 000.

Result**:** SARS will effect a primary adjustment to the transaction in terms of section 31, whereby interest allowable as a deduction will be reduced to the market interest in the amount of R60 000. A secondary adjustment, in the form of a dividend paid to Foreign Parent will be triggered. Dividends withholding tax will be imposed on the R40 000 (less the 28 per cent tax in respect of the reduced interest deduction) on the deemed dividend.

Expansion of the transfer pricing rules

The revised transfer pricing rules technically allow only for the recalculation of "taxable income", thereby limiting transfer pricing adjustments solely to the normal tax. It is proposed that this recalculation cover all taxes within the Income Tax Act (including the new Dividends Tax).

III. Effective date

The proposed amendment will be effective for interest received or accrued on or after 1 April 2012.

4.7 FOREIGN CURRENCY: REPEAL OF CAPITAL GAIN RULES

[Key Provisions: Part XIII, Paragraph 43(4) of the Eighth Schedule; Section 24I(2)]

I. Background

Gains and losses in respect of foreign exchange items (i.e. currency, debt, currency forward contracts and currency option contracts) are generally governed by section 24I. Section 24I annually accounts for unrealised gains and losses with these unrealised amounts taken into account as ordinary revenue or loss.

Currency units and debt of natural persons (and certain trusts) generally fall outside of the section 24I paradigm and are instead subject to capital gains tax on a realisation basis. Realisation for this purpose generally means the conversion of foreign currency (or debt) into a different currency or into a non-monetary asset. This form of gain or loss is based on the pooling method. To determine gain or loss under the pooling method, one must first establish a base cost for the pool of foreign currency. Proceeds from disposals of foreign currency are then measured against a proportionate share of this pooled base cost.

II. Reasons for change

While taxation of foreign currency gains and losses is theoretically sound, this form of taxation is extremely complicated. Taxpayers are often required to spend significant time and resources to review ordinary day-to-day currency movements solely for purposes of the tax computation. These costs often far outweigh the actual tax at stake.

III. Proposal

For the reasons outlined above, the capital gain or loss rules (Part XIII of the Schedule) relating to currency monetary items will be deleted. As a result, gain or loss from foreign currency units (and foreign debt) held by natural persons will no longer be taken into account.

A secondary proposal also amends the capital gain or loss provisions mainly associated with non-monetary assets denominated in foreign currency. These rules will be revised to ensure that a creditor's disposal of foreign debt does not give rise to currency capital gain or loss with other gain or loss aspects remaining within the tax system. Going forward, gain or loss will be solely measured based on differences calculated utilising the foreign currency denomination with the gain or loss translated into Rands after the differences are determined. For instance, if a taxpayer holds a zero-coupon bond worth 100 pounds and sell the bond for 110 Pounds, the gain will be calculated at 10 Pounds with the 10 Pound gain converted into Rands based on the currency during the year of assessment. The Rand-Pound currency differentials between purchase and sale will not be taken into account.

However, the unrealized gain or loss regime associated with section 24I will be extended to account for all trusts, regardless of their engagement in trading activities. Section 24I calculations in this regard are no more difficult to undertake than those required of companies (the latter of which are fully within the ambit of section 24I without regard to any engagement in trading activities).

Natural persons will remain largely outside the scope of section 24I (except for currency trading stock and holdings in forward exchange contracts and currency option contracts). Special trust rules will also become subject to the same section 24I exclusion because special trusts are often treated as natural persons for various purposes of the Income Tax Act.

IV. Effective date

The proposed amendments to the 8th Schedule will be effective for years of assessment commencing from 1 March 2011. The changes to section 24I will be effective for years of assessment commencing from 1 March 2012.

4.8 FOREIGN CURRENCY: MATCHING EXCHANGE ITEM RELIEF

[Key provisions: Section 24I(1) definitions of “affected contract” and “ruling exchange rate, sections 24I(7) and (11)]

I. Background

Section 24I governs the recognition and measurement of foreign currency exchange differences for monetary items (i.e. cash, loans, foreign exchange contracts and foreign currency option contracts). Foreign currency exchange differences are generally recognised for tax purposes on an annual basis irrespective of realisation.

However, annual currency recognition is sometimes waived if monetary items are linked to non-monetary items (because the latter lacks this form of annual recognition). Two waivers exist if certain monetary currency assets are associated with non-financial assets.

One set of rules (dating back to 1993) defers the recognition of exchange differences. More specifically, these deferral rules apply to foreign currency loans used to: (i) acquire, install, erect or construct tangible property, (ii) or to devise, develop, create, produce, acquire or restore intangible property. This deferral largely ends once the associated assets are brought into productive use. A similar deferral exists for certain hedges relating to the foreign currency loans just described.

A second set of rules (dating back to 2002) completely eliminates the recognition of exchange differences. This second set of rules applies to: (i) foreign currency loans used to acquire non-financial, foreign source assets, and (ii) certain foreign hedges relating to the foreign currency loans just described.

II. Reasons for change

The above waivers for monetary currency assets associated with non-financial assets lack cohesion. Both sets of rules are somewhat contradictory and overlapping while possibly containing gaps. The rule for pre-trade loans (and hedges) also more properly reflects the 1993 version of the currency rules. The 1993 currency rules contained certain trade concepts as a trigger; whereas, the 2002 currency rules deleted the trade concept for companies.

III. Proposal

In view of the above, the 1993 deferral rules for foreign currency monetary items associated with non-financial assets will be dropped in favour of the 2002 exemption system. The 2002 exemption system will be expanded beyond acquisition loans (and associated hedges). The revised regime will additionally cover loans (and associated assets) used to otherwise create, enhance or restore those assets.

IV. Effective date

The proposed amendments will apply in respect of inclusions or deductions in respect of years of assessment commencing from 1 January 2012.

4.9 FOREIGN CURRENCY: FOREIGN SHARE ACQUISITION HEDGES

[Key Provision: Section 24I(11A)]

I. Background

Section 24I recognises exchange differences for tax purposes on an annual basis irrespective of realisation. However, if the exchange difference relates to the acquisition of foreign equity shares, the currency recognition is waived largely in line with accounting principles. The purpose of this waiver is to ensure matching – the hedge in this case is being matched against a substantial equity stake in a foreign company (the latter of which does not trigger recognition for currency exchange differences on an annual basis).

In terms of formal requirements, the hedge must be associated with a 20 per cent acquisition of a foreign company by South African residents and is only applicable if the foreign company becomes a controlled foreign company (CFC) after the acquisition. The hedge currency gain or loss must also not be reflected in applicable accounting statements. On the disposal of the hedged equity shares, the currency gain or loss will be taken into account on the capital gains side through a corresponding adjustment to the base cost of the equity shares. Thus, the relief operates similar to a rollover with the added benefit of converting ordinary revenue into capital gain (that may ultimately be exempt by virtue of the participation exemption).

II. Reasons for change

The currency recognition waiver requirements for Income Tax purposes are much tighter than necessary – going beyond the requirements for accounting non-recognition. The tax rules require a 20 per cent acquisition; whereas, accounting would not discriminate against smaller acquisitions that are part of a creeping acquisition that leave a substantial equity stake.

The CFC requirement is also excessive – accounting does not require more than 50 per cent control. In addition, the CFC requirement oftentimes creates problems when target foreign company is subject to foreign ownership restrictions in the foreign country concerned (i.e. a foreign ownership restriction preventing South African control).

Lastly, because of the resident requirement, the waiver will not apply if the foreign share acquisition is indirectly performed through a CFC. No reason appears to exist for excluding CFC acquisitions.

III. Proposal

In view of the above, the currency waiver requirements in respect of hedges associated with foreign share acquisitions will be liberalised. The foreign target must simply be at least 20 per cent owned upon completion of the acquisition. The CFC requirement will be deleted. In addition, non-resident acquiring persons (e.g. CFCs) can participate in the relief.

IV. Effective date

The proposed amendments will apply in respect of inclusions or deductions in respect of years of assessment commencing from 1 January 2012.

4.10 INCENTIVE: HEADQUARTER COMPANY ADJUSTMENT

[Key provisions: Sections 9I]

I. Background

In 2010, a headquarter company regime was enacted to ensure that the tax system did not act as a barrier to the use of South Africa as regional headquarter company (mainly for the Sub-Sahara African continent). The new regime cleared three hurdles – relief from tax on dividends (to and from the headquarter company), relief from the controlled foreign company deemed income rules and relief from transfer pricing (and thin capitalisation) in respect of back-to-back loans.

In order to qualify as a headquarter compan, a South African company must satisfy three criteria:

<u>Minimum participation by shareholders</u>: Each shareholder of the headquarter company must hold at least 20 percent of the headquarter company's equity.

80-20 tax value: Eighty per cent of the tax cost of the assets held by the headquarter company (in the form of equity shares held, amounts loaned or intellectual property) should represent investments in foreign subsidiaries in which the headquarter company beneficially holds at least 20 per cent of the equity.

80–20 receipts and accruals: Eighty per cent of the total receipts and accruals of the headquarter company must be derived from foreign subsidiaries in which the headquarter company holds at least 20 per cent of the equity. The receipts and accruals include management fees, interest, royalties, dividends etc. It should be noted that currency gains and losses are not presently part of this calculation because these gains and losses are not technically receipts and accruals.

In respect of the first two tests, the headquarter company must have always complied with the abovementioned requirements in respect of each year of assessment since the company's inception. This requirement applies to existing companies that wishes to enter the regime (and new companies going forward).

II. Reasons for change

Early experience with the headquarter company regime suggests that certain anomalous requirements need to be removed that render the regime partially impractical. Moreover, early information suggests that certain parties are seeking to utilise the regime to undermine pre-existing tax base. Problems additionally exist in respect of companies with many companies potentially falling into the regime with no desire to do so.

III. Proposal

Relaxation of threshold requirements

The 80 per cent asset and receipts/accruals tests will be slightly relaxed. More specifically, the 80 percent asset requirement will no longer be determined with reference to cash and cash equivalents, such as money market deposits (i.e. assets with a market value equal to base cost). These assets are being removed from the calculation because funds of this nature may arise and be inadvertently held for extended periods without any intention of tax avoidance (when simple planning could avoid this problem without any additional tax charge).

Pre-approval required

In order to promote better control and monitor the incentive (and to limit concerns about undesirable inadvertent entries), the new regime will require pre-approval. In the case of companies formed or established on or after 1 January 2011, this pre-approval may come from either the South African Reserve Bank or from the National Treasury.

Companies formed or established (and effectively managed) within South Africa are deemed to receive approval in respect of the Income Tax Act when approval is received from Exchange Control to treat the company as a foreign company for Exchange Control purposes (pursuant to the headquarter company notice).

Companies formed or established within foreign jurisdictions (but effectively managed within South Africa) must obtain approval from the National Treasury (after consultation with the South African Revenue Service). In order to obtain this approval, National Treasury must be satisfied that the formation or establishment of the company within a foreign jurisdiction will not lead to the erosion of the tax base. National Treasury has the power to set the date from when approval takes effect.

Pre-existing companies (i.e. companies formed or established before 1 January 2011) seeking to enter the regime may do so only upon approval from the National Treasury (after consultation with the South African Revenue Service). National Treasury will provide this approval if satisfied that headquarter company treatment:

will enhance South Africa as a regional headquarter destination;

will lead to the creation of additional skills or related intellectual infrastructure; and

will not lead to the erosion of the South African tax base.

National treasury will again have the power to set the date of approval.

Deemed tax migration

An HQ company effectively operates partially outside typical South African taxing jurisdiction. Under current law, this partial outside status is recognised in the reorganisation rules, which treat headquarter companies as non-resident (i.e. generally ineligible to participate in rollover treatment). Consistent with this treatment, a switch to South African headquarter status will trigger a deemed sale of the headquarter company's shares held by pre-existing shareholders on date of approval. This charge will redcue the opportunity for taxpayers to utilise the headquarter company regime solely to undermine the pre-existing tax base (i.e. pre-existing taxable gain). It should be noted that the legislation has been clarified to ensure that the participation exception does not apply when making a transfer to a headquarter company.

Clarification of controlled foreign company (CFC) relief

The headquarter company regime was never intended to be used as mechanism to generally undermine the CFC regime through the use of an intermediate headquarter company regime set between South African shareholders and foreign subsidiaries. The goal was simply to ensure that headquarter companies do not give rise to CFC tax treatment where that treatment would not otherwise exist. The legislation will accordingly be clarified to better reflect this intention.

Example:
***Facts**:* South African Parent Company owns all the shares of multiple South African companies, including South African Holding Company. South African Holding Company directly and indirectly owns all the shares of multiple foreign subsidiaries.

Result: All of the foreign companies qualify as CFCs regardless of whether South African Holding Subsidiary qualifies as a headquarter company. If South African Holding Subsidiary qualifies as a headquarter company, all section 9D tainted income of the foreign subsidiaries will be attributed to South African Parent Company. If South African Holding Subsidiary does not qualify as a headquarter company, all section 9D tainted income of the foreign subsidiaries will be attributed to South African Holding Company.

Annual reporting

National Treasury has increasingly taken the position that to incentives require annual reporting in order to measure their success and to protect against risks. No reason exists for the headquarter company regime to fall outside this paradigm. Taxpayers within this relief must accordingly submit annual information to the National Treasury (in the form and manner prescribed. It is envisioned that the required reporting in this area will be fairly minimal.

IV. Effective date

The amendment will come into effect on 1 January 2012.

4.11 CROSS-BORDER INTEREST WITHHOLDING ADJUSTMENTS

[Key provisions: Sections 37K, 37L, and 37M]

I. Background

In 2010, Government announced its intention to narrow the cross-border interest exemption in line with international global tax practice. The effect of this narrowing is that interest paid to a non-resident will generally be subject to a withholding tax at the rate of ten per cent. The proposed charge will take effect from 1 January 2013 (to provide time for Government to renegotiate certain tax treaties). However, this withholding tax will be subject to a list of exemptions, such as the exemption for interest from bonds issued by any sphere of Government or in respect of listed debt instruments.

Under the current withholding mechanisms, the person making payment of cross-border interest must withhold. This withheld amount must be paid over to SARS within 14 days after the end of the month during which the amount is withheld.

II. Reasons for change

Although most substantive issues relating to the new withholding tax on interest have been resolved during the 2010 legislative cycle, a few issues relating to the administrative mechanisms remain. Some of these issues include: the nature of the liability, payment due dates and the provision for refunds.

III. Proposal

In view of the above, it is proposed that the following administrative refinements be made. Firstly, the law will clarify that the beneficial owner is primarily liable unless the tax is paid by another (typically the withholding agent). Secondly, the due date will be moved in line with the dividends withholding tax (i.e. the close of the month following the month). Lastly, the revised rules set a three year time limit for refunds from SARS for amounts wrongfully withheld (with only the beneficial owner being entitled to claim). All of these rules are being aligned in accordance with the new Dividends Tax.

IV. Effective date

The proposed amendment will be effective on the date when the withholding tax on cross-border interest is implemented.

4.12 TIMING OF FOREIGN TAX REBATES

[Key provision: Section 6quat]

I. Background

Residents with taxable income attributable to income from foreign sources are eligible for tax rebates (i.e. credits) against South African taxes otherwise due and payable. These foreign taxes must “proved to be payable.”

The rebate system contains special rules to prevent timing mismatches between the South African income tax system versus the applicable foreign tax system. More specifically, situations may arise in which the foreign tax ultimately due may differ from the foreign tax initially claimed (with the ultimate amount either falling short or exceeding the initial amount). Under the circumstances, SARS may re-open tax years (to the benefit or detriment of taxpayers) for a period of six years from date of assessment.

II. Reasons for change

While the tax system (as outlined above) recognises some mismatches between South African taxes due versus foreign taxes due, this recognition is incomplete. The initial mismatch envisioned mainly focuses on foreign tax deviations relating to disputes (e.g. audit challenges, refund claims and litigation). However, this form of mismatch is only part of the picture. Many other timing mismatches simply arise from differences as to when the South African tax system recognises taxable income versus the timing recognition of the applicable foreign tax system.

One common timing mismatch arises from cross-border debt. In the case of cross-border debt loaned by a South African company, South Africa generally recognises income on an accrual basis while many countries impose withholding taxes on a cash basis. As a result, the South African tax system recognises the underlying income before the income is recognised by the foreign country imposing the withholding tax. If the systems are not co-ordinated, the South African lender still receives tax rebates at a later date but the timing of those rebates often undercuts their value as a tax offset.

III. Proposal

Foreign tax rebates will be adjusted to ensure that these rebates are better matched against the time when the South African tax system recognises the underlying taxable income. More specifically, foreign tax rebates will be matched against the year in which the South African tax system recognises the underlying foreign taxable income. This matching will ensure that rebates will apply when these rebates are of the greatest practical use for South African taxpayers.

EXAMPLE:
Facts: South African Holding Company owns all the shares of Foreign Subsidiary (located in Foreign Country X. A cross-border of R5 million loan exists between the two entities with South African Holding Company acting as the creditor and with Foreign Subsidiary acting as debtor. In 2013, R750 000 of interest accrues on the loan in respect of the South African tax system. The interest is paid in 2014 with Foreign Country X imposing withholding in 2014.
Result: South African Holding Company can re-open the 2013 year of assessment due to the withholding tax imposed by Foreign Country X in 2014. This foreign withholding tax can then be applied as a foreign rebate against South African taxes otherwise due for the 2013 year of assessment.

IV. Effective date

The proposed amendment will be effective [??].

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5. VALUE-ADDED TAX

5.1 TEMPORARY RELIEF FOR THE RENTAL OF RESIDENTIAL PROPERTY BY DEVELOPERS

[Key Value-Added Tax Act provision: section 18B]

I. Background

Basic concepts

The supply of fixed property by a VAT vendor is subject to VAT at the standard rate of 14 per cent. The standard rate applies irrespective of how that fixed property is used in the hands of the purchaser.

If the purchaser intends to use the fixed property for residential purposes (either as a dwelling or for residential rental), VAT becomes a permanent cost to the purchaser. The policy rationale for leaving residential rentals outside the VAT base is to ensure that residential rental properties and owner-occupied residential properties are placed on par (i.e. are neutral) to one another.
On the other hand, if the purchaser is a VAT vendor that acquires fixed property for resale (or for commercial rentals); the 14 per cent VAT charge becomes only a temporary charge. In these instances, the VAT vendor purchasing the property can claim input credits for the VAT paid. However, the VAT vendor must also charge VAT on resale (with the sales price increased for the value-added). One common set of role players in this area are developers.

Change in use adjustment

As indicated above, input credits for VAT vendors are based on the assumption that the acquisition is for the purposes of making wholly taxable supplies (thereby giving rise to a VAT charge on resale). Therefore, if a VAT vendor's principal intention is to sell fixed property but subsequently the vendor changes the use/application of the fixed property so that the property is to be used for non-taxable purposes (partly or wholly), the vendor is obliged to make a change in use adjustment. In the case of residential property developers, change in use adjustments commonly arise when these developers shift from a resell intention to a rental application.

II. Reasons for change

Developers that develop residential fixed property (e.g. townhouse complexes) with the principal purpose or intention of supplying that fixed property for sale are sometimes forced to rent these properties due to weak selling market conditions. Current weakness in the property markets and the economic climate has exacerbated this difficulty. In this scenario, rental operations are designed to provide the developer with temporary cash inflows to cover the carrying cost associated with the extended holding of the property.

At a technical level, developers have a VAT change in use of a residential property when renting that property (even if only temporarily). This change in use creates a major problem for developers in economic distress because this change in use places the developer in the unenviable position of being forced to pay VAT on a deemed supply. This deemed supply is made at open market value (at the change in use date). This VAT cost escalates if the developer is forced to rent multiple residential rental properties. All of these VAT charges undercut the cash-flow gains otherwise associated with temporary rentals and may even force certain developers into insolvency.

III. Proposal

Short-term solution: Temporary residential rentals permitted

The VAT rules concerning change in use adjustments for property developers temporarily renting residential properties are problematic from a practical and a legal theory perspective. From a practical perspective, premature imposition of VAT upon developers due to forces outside their control seems questionable as an economic matter, especially if the charge can undermine their continued viability. From a legal theory perspective, a host of questions arise that strike at core concepts within the VAT as a whole (see "Theoretical issues raised" below). Proper resolution of these theoretical issues will undoubtedly require a thorough and time-consuming analysis.

In the meantime, legislative intervention is urgently required in order to ensure that the VAT system does not force certain VAT developers into insolvency. This urgency is highlighted by the ongoing economic global uncertainty impacting the local residential property market. To this end, it is proposed that temporary relief be granted to developers that rent residential fixed properties before intended sale. While not trying to solve the larger legal theoretical issues, developers will be given a maximum grace period of 36 months to rent fixed residential property before sale. This 36-month period commences when the fixed property is rented for the first time. If the vendor rents the residential fixed property beyond the permissible 36-month period, the deemed change-in-use charge will apply. This deemed charge will trigger a deemed supply at market value of the property as of the 36 month cut-off date.

In order to qualify for this relief, the vendor at issue must be a “developer as defined’. As above, property developers will be covered by this proposed interim relief provision for as long as the intention to sell the fixed property remains intact.

Example 1:
Facts**:** Vendor A (a property developer) buys a townhouse for R1 000 000 as stock in trade (i.e. for resale purposes). The vendor fixes the townhouse and after a period of 6 months, Vendor A cannot find a buyer for the townhouse and is forced to rent out the property to cover some of interest costs for financing of the property. Vendor A rents out the property for a 12 month period and is fully committed to selling the property when the opportunity arises.

Result: Vendor A qualifies for relief in terms of the interim provisions as the intention to resell has not been abandoned.

Example 2
Fact: Vendor B (a developer) develops 20 units as part of a townhouse development. Vendor B initially sells 15 of the units off plan. However, 12 months after completion of the development, Vendor B struggles to find buyers for the remaining 5 units. Vendor B opts to rent out the units to cover the interest costs of financing development (at the time of renting, the market value per unit is R2 million). Initially, Vendor B does this as a short term measure but thereafter decides that the rental option is ultimately preferred. Vendor B, accordingly decides to ‘take the townhouses off market’ and use the rental property solely for rental (i.e. Vendor B abandons the sell intention; the market value of a unit at this time is R2,5 million).

Result: Vendor B initially qualifies for the interim relief but is ‘forced out’ when the intention to sell the property changes. In this case Vendor B is subjected to the normal rules governing the change in use adjustment and must account for VAT as of the date that the intention to sell has been abandoned.

Theoretical issues raised

The problem of vendors (i.e. developers) renting fixed property for exempt residential use is not unique to South Africa. When a vendor rents fixed property for an exempt use, three main issues come into consideration: (i) purpose versus application; (ii) consumption versus recoupment; and (iii) rental charged as a proxy for consumption/recoupment. These issues are discussed briefly below.

Purpose versus application

In New Zealand, a few court cases have addressed the situation where taxpayers have acquired fixed property for development and resale but subsequently changed this intention (i.e. temporarily renting those properties for residential purposes due to circumstances outside their control). This, unanticipated rental use has precipitated the question of what is the taxpayer's "principal purpose" and whether an adjustment is required.

In *CIR v Morris*, the New Zealand High Court held that the taxpayer's principal purpose of making taxable supplies continued despite the fact that apartments were simultaneously being used for the separate purpose of making non-taxable supplies by way of residential accommodation. The Court did not consider the extent to which the apartments had been committed to a non-taxable use, but the Court instead referred this issue to the New Zealand Taxation Review Authority for consideration. Upon remittance, the Taxation Review Authority held that there was a change in use.

In *CIR v Carswell Investments Ltd*, the taxpayer was a property development company whose main activity was the acquisition of vacant sections onto which existing houses were located. The taxpayer rented out twenty properties as rental accommodation pending their sale. The New Zealand Commissioner and the taxpayer agreed that the principal purpose for which the properties were held was a taxable one (property development), but the New Zealand Commissioner considered that the renting of houses (which is exempt in terms of the New Zealand GST Act) brought about a change in use that required an adjustment. The taxpayer objected this decision and the New Zealand Taxation Review Authority held that the taxpayer did not change the taxpayer's principal purpose of making taxable supplies. The New Zealand Commissioner appealed to the High Court, which sided with the New Zealand Commissioner.

South Africa's VAT seems to espouse the same approach taken in New Zealand (from a legislative standpoint). A reading of section 17(1) with the section 1 definition of 'input tax' within the VAT Act, specifies, that input tax can only be deducted if the intention or purpose is to make taxable supplies. It is submitted that although the intention of the developer is to sell the unit, the developer changes the application or use of the unit for which a supply is made. VAT, unlike the income tax, does not hinge solely on an 'intention' test, as 'application' seems to be an interdependent but intervening variable. Stated differently, although intention is important for VAT purposes, intention goes hand-in-hand with application or use. As a result, a change in application, brings about a supply by the vendor (refer to section 18(1) of the VAT Act).

Consumption versus recoupment

Taxing consumption

South Africa's approach to change in use adjustments is based on the principle that VAT needs to reflect the consumption of goods or services in a given period. The New Zealand change in use rules apply to industries where vendors make a mixture of taxable and exempt supplies (e.g. financial service providers and some property developers). The change in use rules ensure that private use is taxed. For example, a luxury yacht acquired and initially used exclusively in a chartering business (primary purpose), but at a later stage also privately, is subject to the GST change in use rules. This change in use is to ensure that parity of treatment exists with a similar yacht purchased and used exclusively for private purposes.

It is recognised that the intention of a developer to sell the fixed property that is now being rented for residential purposes, does not change. It is an accepted fact that the developer has changed the use of that fixed property (although arguably only for an intermittent period). The corollary for this change is that current consumption must be taxed, thereby triggering a VAT event, in the hands of the vendor.

Recoupment

Also at issue is the debate of recoupment versus consumption. When a change in use occurs, should the effect be:
To recoup input tax previously claimed by the vendor (i.e. effectively, putting the vendor in the same position as if the vendor had originally incurred the input tax for a non-taxable purpose), or
To tax current consumption in the hands of the vendor?

In New Zealand, the Court of Appeal in the *Lundy Family Trust* case, considered the issue of how to treat adjustments previously made when assets are returned to an original taxable purpose. The New Zealand Court ruled that a vendor can deduct output tax adjustments previously declared. The New Zealand Court also seemed to suggest that output tax adjustments made in respect of the change in use must be capped to the amount of the original input tax deduction received by the vendor. This view seems to sanction the recoupment of previously deducted input tax when a change in use occurs.

Lastly, it is unclear whether the change in use adjustment (be it consumption or recoupment based) is temporary or permanent? A temporary charge seems to infer that the fixed property does not leave the VAT base and that the subsequent sale by the developer is leviable with VAT. At variance is a permanent charge which infers that the asset is 'burnt up' once the deemed charge is made by the vendor and that any subsequent sale is not leviable with VAT.

Rental income as a proxy for consumption/recoupment

As stated, the predicament faced by property developers who temporarily rent out residential units, is fully recognised. It is also fully recognised that the current value of the change in use adjustment (i.e. deemed supply) is disproportionate to the exempt rental income received for lease of the property. Hence, there is a view that a claw-back of the monthly rental income can serve as a proxy:
to tax private consumption in the hands of the developer on a monthly basis; or
to recoup, on a monthly basis, a portion of input tax previously deducted by the developer

It must, however, be borne in mind that this approach is tantamount to subjecting the rental income to VAT, which would lead to its own set of policy ramifications.

In view of the complexities above, a short-term solution to the problem faced by developers is proposed. Once all issues have been fully evaluated, a permanent solution will be put in place to address the problem facing developers that temporarily rent residential fixed properties.

IV. Effective date

According to general principles, the proposed amendment will apply to all supplies of fixed property (i.e. change in use) made by fixed property developers on or after the date of promulgation of this Bill but before 1 January 2015.

5.2 DELINKING VAT FROM TRANSFER DUTY

[Key Value-Added Tax Act provisions: Section 1 proviso (i) & (ii) to “input tax” para. (b); section 16(3)(a)(ii)(bb)]

I. Background

Basic concepts

The purchase of fixed property from a non-vendor is subject to transfer duty as opposed to VAT. If the purchaser is a vendor who acquires the property, the purchaser may receive notional input credits (e.g. these inputs are often available for developers who develop and on-sell fixed property or for vendors using fixed property for non-residential rental commercial use). These notional inputs arise because the fixed property purchased is viewed as second-hand goods.

The rationale for notional input credits when acquiring second-hand goods is primarily based on the need to eliminate double VAT charges on the same value-added. For instance, if a VAT vendor develops and sells fixed property, the selling vendor charges VAT on the sales price. If the fixed property is sold to a non-vendor, the VAT charge is an additional cost for the non-vendor. If the non-vendor further on-sells the same fixed property to a second VAT vendor, the second VAT vendor indirectly bears the cost of the VAT borne by the non-VAT vendor in respect of the initial purchase (and for VAT incurred in respect of improvements). Notional inputs for the second VAT vendor for these second hand goods (i.e. fixed property) eliminate double VAT charges on the same value-added by providing notional input relief in the absence of actual inputs.

Anti-avoidance

In the case of fixed property, notional input credits for VAT vendors are based on the lesser of: (i) the purchase price, or (ii) the open market value of the fixed property; both of which are limited to the transfer duty payable in respect of the purchase. The main rationale for these notional input ceilings is to undermine schemes that seek to artificially inflate notional input claims. These claims were possible because notional inputs are not matched by outputs when a VAT vendor acquires property from a non-Vendor. With the introduction of the transfer Duty limit, notional input credits are instead matched against transfer duty payable.

II. Reasons for change

While the transfer duty ceiling for notional inputs in respect of second-hand fixed property prevents avoidance, the ceiling is arguably unfair. The ceiling generally means that the notional inputs allowed do not fully compensate the VAT vendor for most or all of the VAT probably paid by previous owners. Indeed, no notional input credits are allowed at all for the purchase of smaller residential properties because these smaller properties are free from transfer duty (due to the R600 000 threshold).

Admittedly, rules are needed to prevent avoidance schemes (see Amor van Zyl Trust case and ITC 1686). The question is whether the transfer duty ceiling is the best mechanism, especially since the transfer duty undermines the objective of notional input credits. In this vein, it should be noted that an open market value ceiling exists that equally eliminates the avoidance scheme of inflating prices for fixed properties (without undermining the objective of notional input credits).

III. Proposal

It is proposed that the transfer duty ceiling be eliminated as superfluous. Amongst other limits, the open market value rule will remain intact to prevent the over-inflation of prices. Given the relative ease of valuing local residential properties, pricing manipulation for VAT purposes becomes an extremely risky proposition.

Instead, acquisition of fixed property from non-VAT vendors will be subject to largely the same rules applicable for claiming of notional input tax credits in respect of other second-hand goods. Hence, fixed property notional input credits are deferred to the extent of actual payment (i.e. which excludes promissory notes and loan accounts). Notional inputs in respect of fixed property acquisitions must be deferred further until the fixed property concerned is registered in the vendor's name.

Example:
Facts: Individual directly or indirectly holds all the shares of Property Company and Company X. Company X issues a R1 million promissory note to Property Company in exchange for fixed property. Property Company is a non-VAT vendor, and Company X is a vendor.

Result: Company X cannot claim any notional VAT inputs on the purchase in respect of the promissory note. Notional inputs are allowed only in respect of payment that reduces or discharges liabilities.

The payment rules effectively prevent purchasers from obtaining notional input credits fin respect of seller financed property until payment. Taxpayers seeking to undermine this limitation through indirect seller finance schemes will most likely be in violation of the general anti-avoidance rule.

IV. Effective date

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

5.3 DEFERRED CHARGE FOR UNPAID GROUP MEMBER DEBT

[Key Value-Added Tax Act provision: section 22]

I. Background

Special anti-avoidance rules apply in the case of debt created pursuant to an unwritten agreement. In this scenario, indebted vendors registered on the VAT invoice basis must return VAT inputs previously claimed to the extent these indebted vendors have not paid for previously received supplies within a 12-month period. This required charge-back applies to the unpaid consideration (i.e. the amount outstanding).

The required pay-back provision aims to create neutrality for the fiscus once the creditor is taken into account. The creditor can generally claim VAT inputs in respect of VAT previously paid at any time that the creditor writes off the debt (to reverse the prior output). In terms of the debtor, the charge-back provision is based on the commercial assumption that the creditor will typically write off unwritten debt after 12 months. In effect, the charge-back provision is designed to ensure that the corresponding debtor doesn't delay payment past this 12-month period.

II. Reasons for change

In practice, group companies often do not have written agreements with one another for each VAT transaction processed via loan accounts (because written agreements in this context are too cumbersome). Intra-group loan accounts instead are typically reflected solely as mere accounting journal entries. Group members often operate internal loan accounts for commercial reasons without clearing these accounts for many years (in effect, these loan accounts act as a form of interest free financing for related group company members). Therefore, the current 12-month pay-back provision is unrealistic in a group context.

III. Proposal

It is proposed that the required 12-month pay-back provision should not apply to a debtor with unwritten intra-group debt. Instead the pay-back provision for a debtor in this scenario will be triggered at the earliest date: (i) when the debt is cancelled in the debtor's books of account (e.g. journal entries), or (ii) when the debtor is no longer part of the same group of companies as the creditor.

However, this exclusion from the 12-month rule comes at a price – the creditor providing the supply to the indebted group member is subject to an additional "hurdle" before claiming VAT inputs in respect of the unwritten intra-group bad debt. In addition to the normal write off of the intra-group debt as irrecoverable in the creditor's books of account, the debtor must have recognised the debt cancellation in the debtor's books of account (e.g. journal entries), and the creditor must have evidence that the debtor's books of account contain a record (i.e. journal entry) of the VAT charge-back paid to SARS by the debtor.

The net effect of the amendment is to provide relief for unwritten intra-group debt without placing the fiscus at risk. On the one hand, the debtor is not subject to the automatic 12-month VAT charge-back provision. On the other hand, the creditor can only claim VAT inputs once certainty (and sufficient proof for SARS) exists that the debtor appropriately paid back the VAT charge-back due.

IV. Effective date

According to general principles, the proposed amendment will become effective on or after the date of promulgation of this Bill.

5.4 SYNCHRONISING VAT AND CUSTOMS RELIEF FOR TEMPORARY IMPORTS

[Key Value-Added Tax Act provision: Item No. 470.03/00.00/01.00 in Schedule 1 of the VAT Act]

I. Background

VAT is generally payable when goods are imported into South Africa. However, through the use of a Schedule Item Number (i.e. Item No. 470.03/00.00/.01 of Schedule 1 to the VAT Act), VAT exempts goods that are temporarily imported for manufacturing, processing, finishing, equipping or packing of goods as long as the goods are destined exclusively for export. A corresponding Schedule Item Number also exists in the Customs and Excise Act, whereby dutiable goods are allowed to enjoy a full duty rebate (i.e. Rebate Item No. 470.03/00.00/01.00 in Part 3 of Schedule 4 to the Customs and Excise Act). For practical purposes, SARS Customs officials administer the VAT exemption solely through reliance on the corresponding Customs and Excise Schedule Item Number.

II. Reasons for change

The current VAT exemption for temporary imports is facing operational barriers in the case of duty-free imported goods. This operational difficulty exists because SARS effectively relies on the Customs and Excise Item Schedule to apply the VAT exemption. SARS Customs uses this Schedule Item Number only to clear goods that are dutiable. However, the lack of coverage for duty-free goods causes operational difficulties for Customs officials who are controlling the exemption determination. To date, this issue has mainly impacted platinum and gold imported temporarily into South Africa for the purposes of beneficiation. The net result has been to undermine South Africa’s role as a regional beneficiation stakeholder.

III. Proposal

In order to remedy this anomaly, it is proposed that the current wording of the applicable Schedule Item Number in the Customs and Excise Act (Rebate item 470.03 (Tariff Heading 00.00) of Part 3 to Schedule 4) be amended to additionally include duty free goods. Correspondingly, the VAT Act (Item No. 470.03/00.00/01.00 of Schedule 1) will be amended to mirror the applicable Schedule Item Number in the Customs and

Excise Act. The proposed amendments will ensure that SARS Customs officials can apply the VAT temporary exemption equally for both duty-free and dutiable goods.

IV. Effective date

According to general principles, the proposed amendments will apply to all goods imported on or after the date of promulgation of this Bill.

5.5 INTRA-WAREHOUSE TRANSFERS

[Key Value-Added Tax Act provision: Section 13(2A)]

I. Background

The import and entry of goods into a bonded storage warehouse does not give rise to VAT or customs duty consequences. Goods may also be sold or otherwise disposed of while in the storage warehouse, subject to the permission of the customs authority. If a sale or disposal of this nature occurs, the seller and the buyer are required to complete a declaration evidencing the transfer of ownership. This transfer of ownership will not trigger a liability for import VAT as long as the goods remain in the storage warehouse and have not been entered for home consumption. The liability for import VAT will only be triggered after transfer if the buyer removes the goods from the storage warehouse for entry into home consumption. The buyer is required to complete a customs declaration when this entry for home consumption occurs.

II. Reasons for change

If a buyer removes goods from a bond storage warehouse after a transfer of ownership in the warehouse, a risk to the fiscus exists that the buyer may utilise the value for customs duty purposes (i.e. the value of the goods when first entered into the storage warehouse) as the VAT import value. The buyer will often rely on this value because this value will be lower than the intra-warehouse sale value. Reliance on this lower value is misplaced, however, because the intra-warehouse sale is the best indicator of true arm's length value.

III. Proposal

The valuation of goods entered for home consumption will be changed to reflect intra-warehouse sales before entry. In particular, if a VAT vendor acquires goods located in a bonded warehouse before entry, the value of the goods upon entry for home consumption will instead be deemed to equal the value of the goods taken into account when the VAT vendor acquired the goods. The import value will be ignored.

IV. Effective date

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

5.6 MINIMUM VAT EXEMPTION FOR IMPORTED SERVICES

[Key Value-Added Tax Act provision: Section 14(5)]

I. Background

VAT is payable on the importation of goods and services into South Africa. However, the VAT Act provides for a minimum threshold exemption in respect of certain imported goods. For example, books, newspapers and journals imported by post are exempt if the value does not exceed R100. No similar exemption exists with regard to imported services.

II. Reasons for change

The absence of a minimum threshold with regard to imported services means that VAT is payable on importation no matter how insignificant the consideration. This lack of a threshold creates a compliance burden for the importer and an enforcement burden for SARS even though nominal revenue is at stake. Furthermore, the existence of a threshold for goods with the absence of a threshold for services effectively results in an imported hard copy publication being exempt under R100 while the same on-line publication is fully subject to import VAT.

III. Proposal

In view of the above, the introduction of a minimum threshold exemption for the importation of services will be added that matches the threshold exemption for imported goods. Moreover, the exemption threshold will be set at R500 per supply (with the imported goods exemption being raised from R100 to R500).

IV. Effective date

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

5.7 INPUT CREDITS IN RESPECT OF DISCOUNT VOUCHERS

[Key Value-Added Tax Act provision: Section 16(3)(i)]

I. Background

Manufacturers or producers may issue tokens, vouchers or stamps as part of their normal business activities in order to promote the marketing of their products. The holder of the token, voucher or stamp is entitled (upon redemption thereof) to a discount of the price of goods purchased. The redemption by the holder of the token, voucher or stamp can be undertaken directly from the manufacturer/producer or from an agent of the manufacturer/producer (typically a retailer) vendor.

In the later case, the manufacturer/producer reimburses the agent (retailer) for the discount allowed. In terms of the valuation rules, the monetary value of the token, voucher or stamp is deemed to include the VAT when the manufacturer/producer provides reimbursement.

Example:
Facts: Book Publisher issues R28 worth of vouchers for the promotion of certain books in its catalogue. Individual M redeems a R28 voucher for the purchase of a book priced at R228 at Book Store (an agent of book publisher). Book Publisher reimburses Book Store the R28 discount allowed.

Result: Book Publisher claims a deduction of 14/114 of R28 (i.e. R3.44). The total consideration for the supply made by Book Store is R228 (with the R28 voucher including VAT at 14 per cent).

II. Reasons for change

Deemed inclusion of the VAT for tokens, vouchers or stamps can be problematic. When the holder of a token, voucher or stamp redeems it in respect of a supply subject to the zero rate of tax then unintended consequences may arise. This is best illustrated by way of example.

Example:
Facts: Manufacturer specialises in the manufacture of certain foodstuffs. Manufacturer issues R8 vouchers for the promotion of all of its foodstuffs. Individual N redeems <u>two</u> R8 vouchers at a supermarket store for the purchase of eggs and pilchards (two zero rated items). B subsequently reimburses the supermarket store for the discount allowed on the supply.

Result: Manufacturer claims a deduction of 14/114 of R16 (i.e. R1.96) reimbursed to the supermarket store. This result follows even though no VAT arose in relation to the underlying purchase.

III. Proposal

It is proposed that the anomaly referred to above be removed because the VAT rules were not designed to cater for tokens, vouchers or stamps being redeemed in respect of zero rated supplies. The proposal will result in the vendor issuer of a token, voucher or stamp only being allowed to claim an input deduction if the underlying supply is taxable at the standard rate.

IV. Effective date

According to general principles, the proposed amendment will apply to all tokens, vouchers, or stamps redeemed in respect of goods supplied on or after the date of promulgation of this Bill.

5.8 CLARIFICATION OF ZERO RATING FOR MINING RIGHT CONVERSIONS AND RENEWALS

[Key Value-Added Tax Act provision: Section 11(1) (n)]

I. Background

In 2002, the Mineral and Petroleum Resources Development Act (MPRDA) was introduced, which required holders of old order mineral rights to convert their rights into new order rights after approval by the Department of Mineral Resources. New order mineral production rights cannot last for more than 30 years, but holders can obtain approvals for renewal. Various acts, including the VAT Act, provide relief so that conversions and renewals do not give rise to unfair tax charges when parties remain economically neutral. More specifically in the case of VAT, conversions and renewals are zero-rated for VAT purposes.

II. Reasons for change

The current VAT zero-rating for mineral right conversions and renewals is problematic. Some taxpayers are claiming that the transfer of mineral rights to third parties (outside the conversion or renewal process) fall within the zero-rating even though this extension of the zero rating was never intended. The zero rating is merely intended to protect mineral rights holders from being subject to VAT solely because regulation requires an alteration of rights while those rights remain in the same hands.

Moreover, the need for a zero rating in the case of mining right renewals to avoid adverse VAT consequence is technically questionable. MPRDA renewals should instead be viewed as akin to an extension of licensing rights, which is merely viewed as a non-event (non-supply) in line with common law without specific legislative relief.

III. Proposal

The zero rating provision for conversions (where no ownership of the rights changes hands) would be amended to reflect that only the extent of continuation or conversion of the old order right (as required by the MPRDA) will be zero rated. Further, it is accordingly proposed that the zero rating for mineral right renewals be deleted as superfluous.

IV. Effective date

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

6 OTHER TAXES

6.1 TRANSFER DUTY: RELIEF FOR ENTITIES

[Key transfer duty provisions: Sections 2 and 9 of the Transfer Duty]

I. Background

The Transfer Duty has two different sets of rates. Natural persons acquiring property will be subject to a zero, five of eight per cent charge depending on the value of the immovable property acquired. On the other hand, legal entities (companies and trusts) acquiring immovable property are subject to an eight per cent charge regardless of value.

II. Reasons for change

Many years ago, the higher transfer duty rate for companies and trusts could be justified. At one time, a company (or trust) could be used to avoid the transfer duty by holding immovable property indirectly on behalf of natural persons. Under this scenario, the company share or trust interests could seemingly be sold free of transfer duty even if the legal entity held immovable property as its sole asset. The only transfer duty that could be applied was on the initial acquisition by the legal entity.

With the anti-avoidance amendments of 2002, the acquisition of immovable property companies or trusts now triggers transfer duty as if the immovable property were acquired directly. The enactment of capital gains tax adds further layers of tax. With these changes, the higher transfer duty for legal entities is no longer necessary because the overall tax burden on the appreciation of immovable property within companies or trusts is at least as high as immovable property directly held by natural persons.

More importantly, non-tax reasons often exist for using legal entities to hold immovable property. For instance, many investors prefer to hold rental properties in the form of a company to obtain the benefit of limited liability protection. This limited liability protection protects the investor from excessive losses. The use of multiple companies can also be used so that the separate properties can be protected against the risks of one another. The current flat 8 per cent charge on immovable property companies and trusts creates a cost that makes these commercial uses prohibitive.

III. Proposal

The flat transfer duty rate for legal entities will be removed. All persons (natural and legal) will henceforth be subject to the same graduated rates. Because the differences in transfer duty rates will no longer exist, tax-free “asset-for-shares” (e.g. formations) will now be permitted. It should be noted that the anti-avoidance rules for property legal entities will remain in order to ensure that legal entities do not hold property mainly for tax motivated reasons.

--Suggested drafting instructions

1. **Paragraph (a) of section (2) will be deleted.**
2. **Add section 42 to the list of exempted reorganisations under section 9(l).**

IV. Effective date

The proposed amendment will be effective for any immovable property acquired (or interest or restriction in any property renounced) on or after 23 February 2011.

6.2 SECURITES TRANSFER TAX: TEMPORARY ADJUSTMENT TO THE BROKER - MEMBER EXEMPTION

[Key security transfer tax provision: Section 8(1)(q)]

I. Background

Taxpayers purchasing (or otherwise acquiring) listed and unlisted shares are generally subject to the Securities Transfer Tax. This indirect tax applies at a rate of 0.25 per cent in respect of the share value acquired. This tax (like other taxes) contains a number of exemptions. Among these exemptions, an exemption exists for members purchasing listed shares for their “account and benefit.” In practice, a “member” is a broker with a permit to operate directly on the JSE. A broker can act in capacity as principal or as an agent on behalf of others.

The exemption for member brokers dates back many years to predecessor versions of the Securities Transfer Tax. The purpose of the exemption is to ensure liquidity on the JSE. As a general matter, the 0.25 per cent gross purchase charge should not unduly impact the liquidity of the market due to the low nature of the percentage involved. However, problems may arise when broker members operate as market makers that enhance JSE share liquidity. This market making typically involves short-term trades with profit spreads as low as 0.1-to-0.25 per cent. The current broker member exemption accordingly exists in order to ensure that the Securities Transfer Tax does not disrupt these short-term trades.

II. Reasons for change

Share and share-based products have become increasingly sophisticated since the broker member exemption was introduced many years ago. It has now come to Government’s attention that the broker exemption is being used in circumstances way beyond initially intended.

It appears that certain financial institutions have engaged in many transactions with broker members acting as “principal”. In the most prominent circumstances, these financial institutions are operating as market makers for derivatives. More specifically, the institutions at issue offer derivatives to a client while maintaining a perfectly hedged position with a broker (that is often “connected” in terms of ownership). The broker member would simultaneously hold the underlying shares in that capacity as principal to offset the derivative offered to the institution. The nature of the back-to-back relationship would typically remove all the risks and rewards associated with the position in respect of

the broker member. In exchange for the broker member's participation, brokers in these circumstances would typically receive consideration equivalent to that of a service fee offered to an agent.
At issue is whether these broker members are acting for their own benefit within the meaning of the Securities Transfer Tax. In particular, the concept of "account and benefit" was intended to ensure that the broker had a beneficial interest in the share acquired (i.e. bore the risks and rewards). Review of the law would accordingly suggest that these transactions should at least be viewed as "problematic."

III. Proposal

A. Technical versus policy considerations

Application of the broker member exemption raises two types of issues – one at a technical level and one at a policy level.

- At a technical level, Government maintains its view that the broker member must be operating as the "beneficial owner" of the acquired share to obtain the exemption. Formal treatment as "principal" for JSE purposes is not sufficient by itself to satisfy the standard of beneficial ownership. Were beneficial ownership of this nature is to be accepted, any taxpayer could simply undermine the Securities Transfer Tax by using a broker member as an intermediary (acting in the nominal capacity as "principal").

- On the other hand, the policy issues are not so straight-forward, many of the transactions at issue appear to operate as a form of market making not envisioned by the initial legislation. As outlined above, many of the shares at issue are being used to facilitate market making in derivatives (and seemingly lack a primary tax motivation). Sudden imposition of the Securities Transfer Tax in these circumstances could accordingly disrupt the market, thereby reducing liquidity.

B. Temporary legislation

In view of the above, a two-fold solution is proposed. In order not to disrupt the market, it is proposed that the broker member exemption be expanded to cover all broker member activities wherein the broker member is acting in the capacity as principal. This exemption would allow the parties involved to carry on as before without further tax risk.
On the other hand, the expanded exemption will apply only from 1 January 2011 (roughly when the matter was first raised with Government at a policy level). SARS remains free to enforce the law in respect of acquisitions occurring prior to this date. This proper enforcement should not adversely impact the market because of the expanded broker member exemption will apply going forward.
Moreover, the expanded exemption will only last for a temporary period – i.e. until the close of 2012. This interim period will be used to further investigate whether the transactions at issue provide meaningful value in terms of liquidity and whether the expanded exemption can be maintained without imposing an undue risk to the tax base. Also at issue is the question off competitiveness of the JSE as opposed to the London Stock Exchange. At this stage, it is understood that share acquisitions on the London

Stock Exchange are subject to a 0.5 per cent charge, but this charge contains many more exemptions (i.e. the South African Securities Transfer Tax carries a lower overall rate but with a broader base).

IV. Effective date

The proposed amendment will be effective for transactions entered into on or after 1 January 2011 until the close of 31 December 2012.