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20 June 2011

National Treasury/South African Revenue Service ('SARS')
P O Box 402
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Attention: Ms Nomfanelo Mpotulo & Ms Adele Collins

***Per e-mail*:**
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Dear Ms Mpotulo and Ms Collins,

Herewith, Deloitte commentary on the Draft Taxation Laws Amendment Bill, 2011 issued for public comment on 2 June 2011(refer **Annexure A).**

Should you wish to discuss any aspect, please contact the under-signed 011-209 6013.

Yours faithfully,

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ANNEXURE A

Our comments in respect of the Draft Taxation Laws Amendment Bill, 2011 ("the DTLAB"), issued for public comment on 2 June 2011, are set out below. Our comments follow the structure adopted in the Draft Explanatory Memorandum on the DTLAB, dated 2 June 2011 ("the Explanatory Memorandum"). References in this document to "section" or "sections" are to section or sections of the Income Tax Act No. 58 of 1962 ("the Act") and to "clause" or "clauses" are to clause or clauses of the DTLAB.

As a general comment, we wish to express our concern that the volume and drastic nature of some of the proposed amendments will undermine certainty with regard to application of South Africa's tax laws. Whilst the attainment of absolute certainty is an elusive ideal, the credibility of a tax system requires that investors are able to conduct their business and plan their affairs within a regulatory framework that provides a reasonable degree of certainty as to the tax consequences of their actions. It is our considered view that the DTLAB fails in achieving this level of certainty. We make these observations specifically in relation to the immediate suspension of section 45 roll-over relief, the tax treatment of dividends received on preference shares, perpetual instruments and third-party backed shares and proposed changes to the headquarter company regime. Our specific comments are noted below.

1. Income Tax: Rates and Thresholds

See our comments under 3.10 below.

2. Income Tax: Employment, Individuals and Savings

2.5 Long-term insurance: taxation of proceeds

Insertion of section 10(1)(gG) (clause 30)

Paragraph (i) of this subsection provides that where no portion of the premiums in respect of a long term insurance policy was deductible, the full amount received by the policyholder would be exempt from income tax. The full amount would include any growth in respect of the policy.

Paragraph (ii) provides that where some of the premiums were deductible, then only the portion of the amount received by the policyholder equal to the premiums that were not deductible would be exempt. No portion of the growth in respect of the policy would be exempt. This is inconsistent with the principle applied in sub-paragraph (i).

We suggest that the payout be split between the exempt portion and non-exempt portion in the ratio of the deductible to non deductible premiums.

Insertion of section 10(1)(gH) (clause 30)

Based on similar arguments in respect of section 10(1)(gG) above we suggest that the payout be split between the exempt portion and non-exempt portion in the ratio of the deductible to non deductible premiums

2.6 Medical scheme credits (clause 10)

The DTLAB replaces the deduction system for medical contributions with a credit system. The proposed section 6A will be severely prejudicial for taxpayers over the age of 65. At present, taxpayers over the age of 65 are entitled to a deduction of all medical expenses incurred whether by way of contributions to a medical aid fund or expenses actually incurred on medical services.

The proposal is that the additional tax credit for taxpayers over the age of 65 be an amount of R216 per month. This will be severely prejudicial to taxpayers in that age bracket and will result in significantly increased tax liabilities.

Assume, for example, a married taxpayer, aged 70, with income of R300 000 and medical expenses of R2 500 per month and medical costs not recovered from the medical aid of R20 000. Under the current rules tax payable will amount to R35 983. Under the proposed rules tax payable would be R43 207, an increase of 20%.

3. Income Tax: Business

3.5 Assumption of contingent liabilities: taxable company acquisitions

Section 11F (clause 36)

We support the intention behind the legislation, but there are some open questions.

The provisions of section 11F apply where a business undertaking is disposed of as a "going concern". The Act does not define the words "going concern". However, "going concern" is defined in the Value-Added Tax ("VAT") Act. It is not clear whether the same definition is intended to apply to the Act. If the definition of "going concern" per the VAT Act is intended to equally apply to the Act then the provisions of section 11F may not apply on certain sale of businesses that do not meet the definition of "going concern".

The words "going concern" should therefore be defined in the Act. The dividing line is very often very fine, e.g.:

- the disposal of a partnership interest to the remaining or new partners
- assets which cannot be transferred immediately or at all, e.g.:
  - properties which have not been promulgated or properly registered;
  - leases or similar agreements the transfer of which requires prior consent which may only be granted later;
  - sale of a property to the lessee

Section 11F requires that the market value of contingent liabilities be determined in respect of the disposal of a business undertaking. The Act defines market value in the context of assets and it is not clear what is envisaged by "market value" in the proposed legislation in the context of contingent liabilities. The proposed section should define "market value".

Section 24CA (clause 53)

The third last word of section 24CA(1) should be "acquisition" rather than disposal.

The provisions of sections 11(e), 12C etc should be amended to deal with the inclusion of contingent liabilities in the cost of the assets.

It is unclear in terms of which provision the purchaser would get a deduction once the actual expense is incurred. The legislation should clearly provide for a deemed cost of acquisition in respect of the contingent liabilities assumed.

3.6 Incentive: industrial policy project revisions (clause 41)

The proposed amendments to section 12I propose an increase in the industrial project allowances for both Greenfield projects with a preferred status approval and normal qualifying status approval, establishing in Industrial Development Zones (IDZ). The Projects with 'preferred status' will be increased to 100 per cent and projects with 'normal qualifying status' to 75 per cent.

It is, however, noted that the investment allowance ceilings of R900 million for 'preferred status' Greenfield projects and R550 million for 'qualifying status' Greenfield projects remains for IDZ investors.

For example, a manufacturing plant qualifying as a 'preferred status' Greenfield project will be entitled to claim a tax deduction of 55% of the value of the qualifying assets (R2bn X 55% = R1,1 billion but capped at R900 million). Under the new proposed legislation, the same investor will be entitled to claim a deduction of 100% of the value of the same assets (R2bn X 100% = R2 bn but will still be capped at R900 million). Therefore, major investments of more than R900 million will still not receive any additional benefit for investing into the IDZ's. Investors that will invest in IDZ's where the qualifying investment value is less than R900 million, will benefit, based on these proposed changes.

The proposed change to the legislation that will have major impact on existing projects is the replacement of the word "or" with "and" in subsection (1)(c).

It is our view that this change will impact significantly on investors that entered into a contract but due to the nature of the contract did not acquire any assets. It is important to bear in mind that large corporations consider incentives before making investment decisions. Corporations also compete for available equipment on a global basis and frequently need to order equipment, normally with suspensive conditions, in order to get a clear indication of the lead times and availability of equipment to determine the total cost of the project. We are also not dealing with over-the-counter equipment but with large interactive and interdependent equipment that can sometime take months/years to design and build. The changing of "or" to "and" does not take commercial reality of large projects into account and will result in large projects that meet all the requirements of the legislation being disqualified simply as they need to have firm orders in place in order to satisfy the requirements of financiers (who will

not finance a large capital project unless they have a quantifiable value of the project to be funded). It is also important to note that financial institutions, since the 2008 recession almost always consider incentives in their assessment of the financial feasibility of large projects.

Furthermore, it is proposed that the amendment be backdated to 2 January 2009. It is our recommendation that the constitutionality of such a change be reviewed as taxpayers who have already submitted applications will be severely prejudiced. Where a taxpayer has contracted and applied for an additional deduction it will now be rejected. It is our view that taxpayers who relied on the incentive being available and who made investment decisions based thereon will be severely prejudiced.

We therefore recommend that the proposed replacement of "or" with "and" is rejected, alternatively that the replacement amendment is not backdated to 2 January 2009, but be made effective from 5 January 2012.

3.8 Incentive: research and development revisions (clause 35)

Section 11D(1)

We welcome the inclusion of the definition of "research and development" in subsection (1). This definition is much wider than the definition contained in the current legislation. The proposed definition includes experimental activities which is more in line with the global definition of scientific research and experimental development.

We do however have concerns about the practical implication of the proposed definition as currently worded. Not all research and development ("R&D") activities include experimental activities and therefore by allowing the definition to read systematic investigative "and" experimental activities in section 11D(1)(a) limits qualifying R&D to R&D that include both systematic investigative and experimental activities. As a result, South Africa may miss out on R&D opportunities if "investigative activities" and "experimental activities" do not both occur in South Africa.

It is our recommendation that the word "and" in the first line of section 11D(1)(a) be replaced with "or". This will widen the definition to include R&D that comprises either systematic investigative activities or experimental activities.

We further recommend the inclusion of the word "or" after the semi-colon at the end of section 11D(1)(a)(i).

In the proposed section 11D(1)(a)(i), the word "new" replaces the word "novel" in the current legislation. The regulations for the proposed legislation will determine whether this replacement constitutes a positive or negative change.

We also noted the use of the word "technical" instead of the word "technological" in subsection 1. Considering the difference in the meaning of these words, and that "technological" more likely constitutes R&D, we recommend that the word

"technological" as under the current legislation remains and is consistently applied throughout the proposed legislation.

Furthermore, in section 11D(1)(a)(ii), the word "significantly" is too subjective. The legislation clearly sets out the requirements for compliance of the listed criteria. The word "significantly" can cause confusion to both the taxpayer and the DST and create hesitancy with taxpayers to claim their R&D projects. We recommend that the word "significantly" be removed from the proposed legislation.

We welcome the inclusion of the definition "research and development facility" in the proposed section 11D(1). However, we are of view that the definition lacks the inclusion of equipment normally used in R&D activities and will effectively limit the legislation. The exclusion of the current section 11D(2) in the proposed legislation is cured with the inclusion of the definition of "research and development facility", but the exclusion of "equipment" defeats the purpose of the proposed definition. We recommend a wider definition of "research and development facility" by the inclusion of "equipment" or "assets" which will also be more in line with the proposed subsection 7.

Section 11D(2)

With regards to the proposed section 11D(2), in our opinion limiting the deduction to a taxpayer that is a company and excluding taxpayers other than a company to be entitled to the benefit contemplated in this section does not acknowledge the fact that substantial R&D is performed by Professional partnerships (Engineers, Clinical Research Organisations, etc.). The benefit is also limited with the inclusion of the words "and solely" as appears in line 4 of the proposed section 11D(2). These words imply that the labour costs incurred by an individual cannot be apportioned to the R&D conducted by that individual. As a result, labour costs will be excluded which will cause a reduction in the size of the claims and ultimately have a negative impact on South African R&D.

We recommend that the words "and solely" is removed entirely from the proposed section 11D(2) as it is common practice that some staff may be conducting pure R&D as well as quality control (thus non-qualifying R&D) activities.

Section 11D(3)

Often individuals are conducting R&D that results in large R&D operations in South Africa. It is our view that the limitation in the proposed subsection (3) of a taxpayer to be a company only, is inappropriate and will have a negative impact on R&D incorporation in South Africa. We recommend that this subsection should read the same as the proposed subsection (2) to include companies and non-company taxpayers to benefit from this tax deduction.

The words "contracted for" used in subsection 3(b) are too narrow as employees get contracted by a company on date of employment and not necessarily on date of commencement of R&D. The proposed subsection 3(b) implicates that large portions of salary costs of employees will be excluded if included at all. We are of the view that it is not the intention of National Treasury to exclude salary costs. It is

also questionable whether the words "contacted for" can actually apply to R&D as it is frequently an in-house activity that is not actually contracted for.

It is important that the proposed subsection 11D(3) be read in conjunction with subsection 11D(4)

With regards to the pre-approval system that is referred to in the proposed subsection (3), we reiterate that it is a welcome change to the legislation and the R&D regime in South Africa, as it will provide clarity to the process and to participating taxpayers. It is, however, our view that pre-approval is important before tax return submission and not before the R&D is conducted. A number of countries follow this process. Pre-approval may also be problematic as companies frequently receive requests from customers that result in urgent ad hoc R&D being conducted. Such R&D may qualify for the deduction but there will normally, and depending on process, not be time to apply for, and wait for pre-approval from DST. Pre-approval before tax return submission would add more value than before commencement of R&D, as the uncertainty that exist at the time of commencement of the R&D project may make application too difficult. Ad hoc R&D is not pre-planned and it will be difficult for taxpayers to apply upfront as such application and possible waiting period for approval will delay the process. Consequently, taxpayers will not participate. Also, taxpayers will be hesitant to apply as the process may require the disclosure of information that could threaten their competitive edge if it becomes public knwledge.

Therefore, we recommend the removal of subsection 3()(b) in its entirety.

Section 11D(4)

Under the current legislation, the taxpayer who funded the R&D is entitled to a tax deduction under section 11D. The proposed legislation shifted this entitlement to the taxpayer who conducted the R&D. This change has the effect that the taxpayer taking financial risk with regard to the R&D, no longer gets the deduction. It is, furthermore, also important to note that the shifting of responsibility to the "doer" rather that the "funder" of R&D will increase the number of claimants drastically. The clearest example of this happens in the Clinical Research Industry where one Clinical Research Organisation (CRO) will fund 40 to 50 doctors to conduct R&D under its control. Previously only the CRO qualified, now 40 to 50 doctors will.

Section 11D(6)

The proposed subsection (6)(i) excludes overhead costs of research and development. It is our view that overhead costs should not be excluded. We recommend that subsection (6)(i) be deleted.

Section 11D(7)

The proposed subsection (7) affords the taxpayer an additional 50% on expenditure incurred in respect of any research and development facility as defined in the proposed subsection (1). It seems that the purpose of this section is to compensate for the exclusion of the current section 11D(2), but with an additional 50% deduction. We welcome this additional benefit, but have to question why referral has only been

made to sections 12C and 13 and not to section 11(e) at all. Sections 12C and 13 cover the benefit in respect of assets or equipment applied for manufacturing, whereas section 11(e) sets out the general deduction in respect of the same assets or equipment. It is our view that section 11D(7) should also refer to section 11(e) as it refers to the same assets or equipment and is therefore also relevant.

We recommend the inclusion of the referral to 11(e) in this proposed section and also that section 11(e) is amended to refer to equipment used for R&D or to refer to the definition of the R&D facility as per our recommendation, as contemplated in the proposed section 11D(1).

Section 11D(8)

This proposed section relates to the pre-approval process that National Treasury intends to implement with the introduction of the proposed legislation and lists the criteria to be met in order to obtain such approval. It is our view that the criteria raise concerns with regards to the detail of an R&D project that is required in order to be approved. Taxpayers intending to conduct R&D do not always have this level of information about their projects at the outset. Also, taxpayers may not know the extent to which the R&D will provide synergies with other R&D or economic activities within the Republic.

The proposed subsection (3) relates to a pre-approval process before commencing with R&D. It is our view that the detail of the criteria set out in subsection (8) should not be applied to subsection (3). We thus recommend that the referral to subsection (3) in subsection (8) should be deleted and we suggest that the criteria in subsection (8) is widened by replacing "and" with "or" throughout this section.

It is questionable whether it is intended that a major innovation that qualifies for a deduction in all aspects be disqualified as "it does not lead to job creation in the Republic".

Section 11D(10)

This proposed section raises our concerns about the inclusion of a pre-approval process without any final approval prior to tax return submissions. This section only requires for a progress update to an adjudication committee, but does not provide for final approval of the R&D by the committee. We would like to see that the technical merits of the R&D case are approved before the taxpayer submits his/her tax returns, rather than a pre-approval prior to the commencement of R&D. This will provide the taxpayer with peace of mind that the R&D projects will not technically be rejected by the SARS which we welcome.

We recommend that the proposed section be amended to read-

"Within 12 months after the close of each year of assessment, and prior to tax return submission, starting with the year in which approval is granted in terms of subsection (8),..."

We further request that similar conditions to the conditions set out in subsection (8), are included in this subsection (10). The R&D claims will be prevented from being partially rejected because the technical part and costing part of an R&D case do not correlate.

Section 11D(12):

It is our view that the wording of this section is too broad. The implication of this section will be that if any information of the taxpayer is outstanding, e.g. a VAT return, the claim runs the risk of being rejected. An R&D claim worth millions of rand can thus be rejected as a result of documentation unrelated thereto being outstanding.

It must be clearly defined what "disclosure" with regards to R&D is required.

Section 11D(13) and (14):

Both these sections already appear in other parts of the Income Tax legislation. Therefore, it is not required in our opinion.

Section 11D(15):

We appreciate the implementation of an adjudication committee to evaluate and approve the proposed R&D. We agree with the compilation of the committee to be represented by DST, National Treasury and the SARS. It is our view that the involvement of all the relevant authorities will ensure correlation of both technical and costing aspects of a claim as well as reassurance that the approval process happens within the rules set out in the legislation. It is however, questionable whether a committee of 8 people will be able to adjudicate all R&D conducted in South Africa.

Section 11D(19):

We agree with the content of this proposed section. We however recommend the implementation of an appeal process. Such a process will be encouraging to taxpayers knowing that in case where the Commissioner disallowed a claim, they still have the opportunity to defend the claim.

We recommend that this subsection is amended to include the benefits set out in the proposed subsection (8).

General

National Treasury proposes that the changes become effective on 1 January 2012. It is our view that the proposed section 11D becomes effective from the financial year of the taxpayer, commencing on or after 1 January 2012 to avoid two separate claims in one tax year being dealt with by the taxpayer. It is also important to note that the shifting of qualification from "funder" to "doer" may complicate the implementation date.

3.9 Incentive: film production revisions (clause 43)

We welcome the proposed revisions and believe that they will result in more investment in the South African film industry. We do, however, have a concern is that the change will only apply to film projects where principal photography commence on/after 1 January 2012. In our opinion this will result in a decline in funding activity for the remainder of the year. We therefore suggest that the exemption should apply to all projects where principal photography commenced on/after the date of the budget speech or for all tax years commencing on/after 1 March 2011.

We also note that there are now two pre-approvals. The first pre-approval requires that a film' must conform to the requirements stipulated by the Department of Trade and Industry in the Programme Guidelines for the South African Film and Television Production and Co-production Incentive.

It is must be noted that not all films apply for the DTI's incentive programmes. It is also important to note that, in terms of the proposed legislation, films that apply, and qualify for the "Location Film and Television Production Incentive" do not qualify for the exemption. We suggest that this be addressed and that films qualifying for either the South African Film and Television Production and Co-production Incentive or the Location Film and Television Production Incentive qualify for the exemption.

The second approval requires approval by the National Film and Video Foundation in terms of section 3(c) read with section 4(1) of the National Film and Video Foundation Act, 1997 (Act No. 73 of 1997) as a domestic production or co-production whereby a film is co-produced of in terms of a co-production agreement between a South African citizen and a citizen of any other country;

It is important that it be borne in mind that there are not co-production treaties with all countries. A SA citizen may therefore be involved in a production where the citizen of the other country resides in a country without a Co-production treaty and the NFVF may therefore not approve such film as a co-production.

We also fail to see how the NFVF will report annually, for a period of 10 years, based on the information at its disposal. We suggest that the DTI be responsible for this report as it will in any instance evaluate projects in terms of the NFVF's processes and as this will eliminate another bureaucratic process (the NFVF approval).

3.10 Small business: micro-business turnover tax relief

A number of changes have been proposed to encourage people to register for the turnover tax. However, there are still a number of barriers that should be addressed:

- A maximum of R1m for registration is very small. It means this dispensation applies to people who have a monthly turnover of less than R84 000;
- It is not clear why people who are providing professional services should not be part of this dispensation; and
- The schedule does deal with temporary fluctuations above the R1m threshold. A single once off sale requires a person who meets the threshold under

normal circumstances to deregister within 21 days if such a person exceeds the R1m threshold. This creates uncertainty to people who may want to register for the turnover tax.

3.11 Debt cancellation: character issues

It is proposed to include in paragraphs (i) and (ii) of "gross income" an amount for the partial or full relief from any liability (subject to the capital or revenue test). The proposed amendment is deficient in a number of respects.

Firstly, we question whether the amendment is needed at all. The Act in its existing form deals with debt discharges both on income account (section 8(4)(m) and section 20) and on capital account (para 12(5) of the Eighth Schedule to the Act) and we question the need for the overlay of another provision.

Secondly, it is not clear how the proposed amendment will interact with the existing provisions. If the amendment becomes law in its proposed form, it would appear that double taxation would result. There is also a need to provide similar relief as under para 12(5) of the Eighth Schedule.

Thirdly, the provision is badly worded such that the payment of a debt could be interpreted to provide relief and hence to result in a gross income inclusion. This is clearly untenable. The reference to "by way of partial or full relief from any liability" also needs to be clarified, i.e.:

- if actual liabilities are "assumed" by the purchaser in part settlement of the purchase price, the seller would arguably be relieved from the liability, but it should not trigger an inclusion in "gross income";
- if actual liabilities are paid on behalf of the seller as and when they fall due in part settlement of the purchase price, the seller would not be relieved of that liability;
- there should only be an inclusion for amounts which qualify for deduction in the seller's hands in terms of section 11F, i.e. contingent liabilities transferred as part of a "going concern" ;
- these provisions need to be aligned with those in para 35(1) of the Eighth Schedule.

Fourthly, it needs to be ensured that this amendment does not override the Corporate Rules in terms of which the seller is deemed to have disposed of the assets at tax value/base cost.

In summary, we request that the proposed amendment be dropped.

3.17 Dividend tax: revised treatment of capital distributions

The Explanatory Memorandum states, at page 66, that "*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 1 July 2011, the capital distribution amount is added to the proceeds of the share disposal. The 1 July 2011 date 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)*"** (our emphasis).

It is not clear from a review of the proposed amendments to paragraphs 76, 76A and 76B how effect is given to the extended deferral referred to in the Explanatory Memorandum. Further, it is not clear how this deferral will allow "*these capital distributions to enjoy the benefits of the new regime*". Paragraph 76A(1)(a) will stay in effect until 1 April 2012, when the replacement paragraph in the bill comes into operation. In terms of the existing wording, if a capital distribution has been received by or accrued to a shareholder on or after valuation date but before 1 October 2007 in respect of a share not disposed of by 1 July 2011, that shareholder must be treated as having made a part disposal. The proposed amendments do not seem to deal with how deferral until 1 January 2012 is achieved.

Further, paragraph 76B does not appear to deal with a return of capital received prior to 1 January 2012. It is not clear how a return of capital (capital distribution) received between the valuation date and 1 October 2007 would fit into paragraph 76B, and thus "*enjoy the benefits of the new regime*".

Paragraph 76A is amended by the substitution of subparagraph 1, which refers in subsection (a) to *"an unbundling transaction contemplated in section 41"*. This reference should presumably be to section 46.

3.18 Dividends tax: collateral definition issues

Contributed tax capital

The definition of contributed tax capital does not cater for situations where one class of shares issued by a company is converted to another class of shares. It is not clear from the definition whether the contributed tax capital of the first class of shares would convert as contributed tax capital of the second class of shares. We therefore recommend that the definition of contributed tax capital be amended to cater for conversions of classes of shares.

The words "for the benefit of" any shareholder need to be clarified.

Dividend

The reference in para (a)(ii)(cc) of the dividend definition to "subparagraph (b) of paragraph 5.67" of the JSE Listing Rules should be to "subparagraph (b) of paragraph 5.67(B)".

The words "for the benefit of" any shareholder need to be clarified.

Return of capital

Does para (b)(i) not also include a normal dividend, which would be too wide?

3.20 Dividends tax: new dispensation for foreign dividends (clause 30)

We represent a number of foreign companies which are dual listed companies. Our reading of the amendments to the dividend exemption under section 10 of the Act results in the taxation of dividends declared by such dual listed companies in respect of JSE listed shares. These dividends will also be subject to the dividend withholding tax (as from 1 April 2012).

In amplification, clause 30(1)(o) of the DTLAB amends section 10(1)(k) of the Act by deleting section 10(1)(k)(ii) in its entirety. Section 10(1)(k)(ii)(bb) deals with the exemption of dividends in respect of dual listed shares of foreign companies assuming the various requirements are met. In terms of the DTLAB, the gross income definition has specifically been amended to include foreign dividends. The proposed section 10B which deals with the exemption of foreign dividends however specifically excludes "foreign dividends contemplated in section 64D" which we read to be dividends declared by foreign companies in respect of their JSE listed shares. Consequently it would seem that dividends declared by such a dual listed company on its JSE listed shares are no longer exempt as clearly they are foreign dividends as defined in the Act. These are included in gross income and there is now no mechanism which exempts these dividends.

Based on the Explanatory Memorandum it would seem that dividends declared by dual listed companies on their JSE listed shares should be treated in the same manner as dividends declared by resident companies. This would mean that these dividends should be exempt from tax under section 10(1)(k) and subject to the dividends withholding tax if applicable. The legislation should be amended to give effect to this stated intention.

3.21 Dividends tax: dividend stripping adjustments

Section 116(1)

The amended paragraph 19 is inconsistent in its references to a period of two years and 18 months. This should be rectified.

3.22 Anti-avoidance: suspension of intra-group approvals

It is proposed that section 45 of the Act be suspended for a period of 18 months. The suspension was issued without warning to taxpayers and does not provide for a window period to allow for current restructuring transactions to be finalised.

According to the National Treasury Media Statement and Explanatory Memorandum one of the reasons for the suspension of section 45 is to avoid the use of this section in so-called debt pushdown structures. It is also stated that section 45 was never enacted with the purpose of facilitating corporate acquisitions. It is finally contended that section 45 is used in funnel schemes to provide a tax deduction in the production of exempt dividend income.

We do not agree with the suspension of section 45 in the form proposed.

Firstly, section 45 plays an important role in the world of corporate acquisitions and acts as a vital 'release valve' in allowing taxpayers to fund their acquisitions with deductible debt. This is well known by SARS and National Treasury who for years have apparently silently acquiesced in the use of section 45 for corporate acquisitions. This stems directly from the unsatisfactory tax position in this country whereby taxpayers are denied any tax deduction for interest incurred on loans obtained to fund the acquisition of shares. It is often simply not feasible for an acquiror to buy the assets of a target. If section 45 is not available to provide tax relief to the acquiror in respect of its funding requirements a number of corporate acquisitions will become unaffordable.

Secondly, we understand National Treasury's and SARS' concern with the use of funnel schemes that are purely tax driven and that seeks to erode the tax base. We recommend that the targeted anti-avoidance legislation be introduced to address the issue. In any event, we do not understand why SARS does not seek to apply the General Anti-Avoidance Rule ("GAAR") to target these unacceptable schemes. Much time and effort was spent in enacting the GAAR yet there seems to be a singular lack of appetite to use it as an effective weapon in the war against impermissible tax avoidance. This is mystifying and very unfortunate: the sooner SARS starts using the provision the quicker judicial precedent will develop that will highlight the strengths and any deficiencies in the legislation. The failure to use the GAAR means we are presented with legislative interventions such as the proposed section 45 suspension which has the unfortunate effect of penalizing the majority of taxpayers for the actions of an errant minority.

Thirdly, we reiterate our comments in the introduction above that a summary suspension of an important provision such as section 45 undermines tax certainty and impinges on the credibility of our tax system.

We therefore urge National Treasury and SARS to urgently engage with taxpayers to rescue section 45 from oblivion. Possible options to consider include prescribing certain debt:equity ratios to avoid companies being flooded with debt and unreservedly permitting intra-group transactions where assets are transferred at book value as opposed to market value given the reduced scope for impermissible tax avoidance in these circumstances.

3.23 Anti-avoidance: dividend cessions

Insertion of proviso (ee) to section 10(1)(k)(i) (clause 30)

The Explanatory Memorandum (3.23 Anti-Avoidance Dividends Cessions – III Proposal – A. Overall Concept) states "*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.*" The Explanatory Memorandum then states that in respect of the "*automatic trigger*" the amendment would apply "*without regard to whether the underlying shares are held as trading stock or as capital*". If the share is held momentarily it is difficult to envisage how the share could be held as capital. Clarity is required on how the proposed amendment would apply. The wording of the

amendment seems to indicate that the dividend would be included in income in circumstances where the taxpayer received a dividend that was declared prior to the taxpayer acquiring the shares (that is, the taxpayer acquired the share after the dividend declaration date but before the accrual i.e. the last date of registration ("LDR date")). If this was the intention of the amendment, we are of the view that the impact of the section should be limited to shares acquired as trading stock only. For shares acquired as capital assets there should be a reduction in the base cost of the shares rather than the inclusion in income. This would provide symmetry with instances where the taxpayer acquired the shares after the LDR date. In theory the taxpayer would pay a reduced price for the shares ex-div resulting in a lower base cost.

3.24 Anti-avoidance: debt without set maturity dates

The amendment in the newly proposed section 8G seeks to treat "perpetual instruments" as equity rather than debt by deeming any amount paid in terms of such instruments to be a non-deductible dividend in the hands of the payer and the recipient.

This amendment should be read with the proposed amendments in clauses 20 and 21 pertaining to hybrid equity instruments and third-party backed shares, and we refer you to our comments under 3.25 in this regard. As a general comment, we are concerned that the proposal to treat debt as equity and equity as debt is to misconstrue the different legal natures of the two instruments and their respective roles in commercial life. We are also not sure whether the implications of the proposals have been thought through in a cross-border context. For example, would a dividend amount re-characterised as interest be subject to the dividend withholding tax or interest withholding tax rates in terms of a double taxation agreement? We therefore recommend that the proposed amendments be dropped or at least deferred until their full import is assessed.

The definition of "perpetual debt instrument" in the newly proposed section 8G is very wide. In theory this could also cover a bank overdraft. Whilst a bank overdraft is repayable on demand it does not have a fixed repayment date. We suggest that instruments that are repayable on demand but have no fixed repayment date be excluded from the definition of perpetual debt instrument. An overdraft would not qualify as a demand instrument as a demand instrument is an instrument that grants the holder the right to demand repayment before the redemption date per the instrument. An overdraft does not have a redemption date.

The proposal will substantially alter the economic positions of both the issuer and the holder as the issuer will going forward not be able to deduct the interest paid while the holder will not be taxable on the interest received. Generally therefore the holder will be substantially advantaged while the issuer will be similarly disadvantaged. In cases where instruments do not have an "escape clause" to change the existing terms of the instrument in the event of a change in the tax treatment of the instrument, the proposal can lead to great inequity between the parties to the instrument. Consequently, if the proposal is going to be implemented, we strongly believe that it should not apply to instruments already in existence.

We question whether the proposal is necessary. As a "perpetual instrument" is currently defined it will have very limited application given the requirement that the instrument *"the terms of which do not specify any date on which all liability to pay all amounts in terms of that instrument will be discharged*". It would be very rare for an instrument to make no provision whatsoever for its eventual repayment and such provision would, in our view, constitute a repayment date albeit a contingent one.

Subsection 2 of the proposed section 8G deems all amounts paid or incurred by an issuer in terms of a perpetual instrument to be a dividend. This provision appears to be too broad as, as currently worded, it deems a repayment of capital subscribed on the instrument to be a dividend.

3.25 Anti-avoidance: third-party backed shares (clause 21) and hybrid equity instruments (clause 20)

The amendments proposed in clause 20 and 21 are based on the view that if a share is classified as debt in terms of the accounting rules it should also be classified as debt for tax purposes. This is particularly evident in the treatment of preference shares.

In our view, it is simply wrong to equate preference share funding with debt funding. Fundamentally, a preference share is different to a debt instrument in regard to the rights and obligations that it creates. The fact that accounting requires that it is shown as debt on the balance sheet is irrelevant. Our tax law is replete with examples where accounting and tax diverge, for example in the treatment of financial leases and share-based payments.

If a preference share is truly nothing more than debt then it should be taxed in terms of section 24J. It is highly inequitable, though, to treat a dividend payment as a non-deductible expense from the perspective of the taxpayer but as taxable interest in the hands of the preference share holder. Moreover, inasmuch as there may be concerns that a preference share is used as disguised debt, the existing section 8E provides adequate protection to the fisc.

We therefore believe that the amendments proposed in clauses 21 and 22 are not required and our comments below should be read in this light.

Clause 21

The definition of "third-party backed share" in the newly proposed section 8EA of the Act is very wide and could potentially catch a number of legitimate (non-funding) transactions. An example would be where a taxpayer has held a share for a number of years and to protect itself from an expected decline in the value of the share the taxpayer concludes a put in respect of the share. Another example, "tag along" clauses in a shareholders agreement could require that in the event of a sale by any one or more shareholders the remaining shareholders may have the right to require the potential purchaser to acquire their shares as well. These shares would now be classified as a third party backed shares with the consequential tax implications. Any put entered into by a holder of shares would make the shares a third party backed share in terms of the proposed amendment. Most "funding" transactions using shares usually occur upfront when the shares are issued or acquired. We would suggest that

a share only be a third party backed share if the right of disposal, guarantee etc. is in place at the time the share is acquired by the taxpayer or forms part of the acquisition.

This section could potentially result in double tax in respect of taxpayers that do not qualify for exemption from dividends tax (for example an individual taxpayer). The dividend would be subject to dividends tax and included in income in terms of section 8EA. We recommend that a mechanism be inserted that would allow the taxpayer to claim the dividend tax in respect of the dividend as a credit against the normal income tax payable.

Section 8E (clause 20)

The proposed amendments apply to dividends received or accrued after 1 April 2012 and will affect existing shares issued which do not have at least a ten year life. The Explanatory Memorandum seems to indicate that for existing shares, provided certain conditions are met, a written application may be made to exclude dividends from the proposed provisions. This application process is only included in the proposed section 8EA and is not included in section 8E. We strongly recommend that section 8E includes this application option to obviate the negative tax results that could be visited on "innocent" taxpayers.

We suggest that the wording of section 80M(2)(a) which deals with reportable arrangements in respect of hybrid equity instruments be amended to remove the wording "*..,if the prescribed period has been 10 years*" as section 8E now provides or a ten year period in any event.

We are in any event of the view that the existing 3 year period and the definition of "date of issue" in section 8E are more than adequate to protect the fisc against any disguised debt instruments. We are therefore strongly of the view that the 3 year period be retained in favour of the proposed 10 year period.

4. Income tax: international

4.1 Rehaul of the controlled foreign company (CFC) regime

Clause 27(1)(o)

The newly inserted subsection 9A(a)(iii)(aa)(A) refers to *"**less** of those principal trading activities..."*. From the term "less" it is not clear what test would need to be performed. . We suggest that it be worded as follows: *"the activities in the country of the foreign business establishment are more than activities carried on in any other single country"*.

Clause 27(1)(o)

The exemption from imputation of rental income only extends to operating leases (refer section 9D(9A)(a)(iv)). We fail to see why the exemption should not be extended to finance leases.

Clause 27(1)(c)

In terms of clause 27(1)(c), a foreign company is now defined to include a headquarter company. This inclusion of a headquarter company in the definition of a foreign company could result in a headquarter company qualifying as a CFC and consequently in a potential net income imputation of the headquarter company's income to that of a resident shareholder. We do not believe that this could have been intended and believe that a headquarter company should not be defined as a foreign company for purposes of section 9D. We note that the existing CFC legislation makes it clear that the income of a CFC owned by a headquarter company must be imputed to the resident shareholders of the headquarter company. The proposed amendment is therefore superfluous.

4.3 Special foreign tax credit for management fees

Section 6quin

We welcome the insertion of the proposed section *6quin* and have the following comments.

The section only provides for relief when an amount has been "paid". This is an unnecessary limitation. Relief should also apply if an amount has accrued. The term "accrual" should therefore be included as part of section 6*quin*(1)(b)(ii).

Section 6*quat* (2) provides that a taxpayer can claim relief either in terms of section *6quat* or the relevant DTA. We submit that the wording of section 6*quin*(3) should mirror that of section 6*quat*(2). We further submit that section *6quin* should also permit a carry-forward of tax credits for a seven year period as is the case under section *6quat.*

Section 6quat

Section 6quat (1C) should not be deleted. It needs to remain as a "fall-back" provision.

4.4 CFC restructuring

Asset-for-share transactions

Section 42 will henceforth permit an asset for share transaction where a resident disposes of equity shares in a foreign company to another foreign company. The proposed para (b)(aa) of the definition of "asset-for-share transaction" requires that the person disposing of the shares should hold a qualifying interest in the "foreign company" and not the "other foreign company". This seems incorrect.

It would also appear that the amended section 42 only applies to situations where a resident enters into a transaction with its CFCs. This section should be expanded to also allow for transactions between CFCs within a current group of companies.

Amalgamation transactions

The definition of "amalgamation transaction" in section 44 has a proviso requiring a 95% shareholding requirement for the unbundling of foreign companies (refer subsection (1)(b)(ii)(aa)). It is unclear why this application would need to be restricted with a requirement of a 95% shareholding? Why does the application need to be so narrow, if one already is already required to have a group of companies?

4.10 Incentive: headquarter company adjustment (clause 29)

In terms of the newly proposed section 9I, a newly established headquarter company needs to be approved before obtaining headquarter status. The approval will only be granted if it would not lead to an erosion of the tax base. We believe this sends completely the wrong signal to foreign investors interested in establishing headquarter companies. The various tests that must be satisfied in order to obtain headquarter status must surely be a sufficient safeguard against any concerns about an erosion of the tax base. Furthermore, if the legislator does not want existing companies to qualify as headquarter companies, it could simply legislate this.

As regards the receipts and accruals test that must be satisfied to qualify as a headquarter company, it is not clear whether foreign exchange differences should be ignored in determining whether the 80% test is met. The Explanatory Memorandum is of the view that forex differences should be excluded, but it is desirable that the legislation explicitly spells this out.

6. Other taxes, exemptions and allowances

Amendments to section 57 (clause 78)

The removal of the ordinary course of income test in section 57 of the Act would mean that potentially any donation made by a private company with one shareholder would be deemed to be a donation by the shareholder as the shareholder controls the business. Consequentially it could be contended that all donations made by the company (including those in the ordinary course of business) are at the insistence of the shareholder. We would suggest that the ordinary course of income test be retained.

Amendments to section 42 (clause 73)

The proposed reduction of CTC under section 42(3A) is unwarranted to the extent that section 42 relief is inapplicable to the asset disposed of. The draft legislation should be amended accordingly.