The Standing Committee on Finance
Parliament of the Republic of South Africa
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21 June 2011

Chair,

Representations on the draft Taxation Laws Amendment Bill, 2010

We present herewith PwC's first set of written submissions on the above-mentioned Bills.

In this set of submissions, we include only what we consider (at this stage) to be the most critical matters. We intend to more comprehensively cover the bulk of our representations in our submissions directly to National Treasury, the deadline for which is 5 July 2011.

We have tried to keep our submissions concise, but this does mean that you might require further clarification. In this respect, we have requested the opportunity to present oral submissions at the hearings scheduled for 21 June 2011.

Although National Treasury has requested that we should present our submissions in a sequence that mirrors their Explanatory Memorandum ("EM"), we have —*for the purposes of our submission to this Committee*— simply listed them in order of importance. Naturally, we undertake to respect National Treasury's request in our more comprehensive submission.

Our initial representations relate to the following areas:

General submissions

1. The submissions process
2. Perceived policy changes on acceptable debt
3. Specific versus General anti-avoidance provisions

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4. Proposals welcomed

Specific submissions

5. Suspension of section 45
6. Reclassification of dividends and interest
7. CFC re-organisations
8. Foreign dividend exemption
9. Perpetual debt
10. Removal of VET / Extended dividend definition
11. Headquarter companies

General submissions

1. The legislative process: Opportunity for interaction with the Committee

1.1 Every year, for at least the last four years, we have submitted that the period from the initial release (of the draft legislation) to the deadline for submitting representations to this Committee is insufficient. In 2011, the incredible complexity of the proposals highlights (even more than in previous years) that it is unreasonable to expect taxpayers and tax practitioners to properly consider the proposals in order to make more comprehensive and balanced submissions to the Committee.

1.2 Whilst we appreciate and value the ever-improving direct interaction with National Treasury, we remain concerned about the limited opportunity that the public has to express their views to the Committee. Specifically, we note that:

- Last year, for example, our submissions letter to the Committee (in respect of the 2010 draft Taxation Laws Amendment Bills) comprised 10 pages whereas our subsequent submissions (on the same Bills) around two weeks later to National Treasury, comprised some 58 pages.

- Furthermore, there are occasionally new provisions in the final Bill that do not appear in the initial draft Bills, in respect of which there is currently no opportunity at all for submissions to be presented to the Committee.

1.3 On the one hand, we applaud the processes that National Treasury and SARS have initiated from their side, including (for example) :
- National Treasury's "Annexure C Workshops" held towards the end of 2010;
- The public workshops to discuss taxpayer submissions on the draft Amendment Bill (this year scheduled for mid-July).

1.4 On the other hand however:

(a) the time between the public release of the draft bills and the deadline for submissions to the Committee remains grossly inadequate; and

(b) taxpayers still only have one single opportunity to present their perspectives to the Committee (and thus to Parliament).

We would re-emphasise at this point, the volume and complexity of the proposed amendments.

1.5 These matters have been raised several times in past years, and several assurances have been received that they would be addressed. Although we have not duplicated here the detail of our submissions from previous years, they remain in point this year again.

1.6 Submissions:

- There should be a greater consultation period between the initial release of the proposals and the deadline for submissions.
- There should also be an opportunity for "rebuttal" hearings before the Committee, after National Treasury has presented its Response Document.

2. Perceived policy changes on "acceptable" debt

2.1 Despite being presented as "ant-avoidance measures", many of the 2011 proposals represent, in our view, a change-of-policy in respect of the acceptability of certain levels of debt and certain types of debt instruments.

2.2 The perception that taxpayers have developed over the last few years (of what is considered to acceptable) is based on, *inter alia*:

- interaction with SARS and National Treasury on what is considered to be unacceptably aggressive (e.g. so-called "funnel schemes");
- Recent SARS Binding Private Rulings that permit interest-relief for debt that funds the acquisition of shares (e.g. BPR063 & BPR066 in 2009).

2.3 The change-of-policy that appears to have come in the form of wide-ranging proposals that are, in many respects, retrospective in effect and which now create confusion on what precisely National Treasury's position is on debt funding.

3. The overly broad and harsh anti-avoidance measures

3.1 We place on record that we do not promote aggressive tax schemes which are aimed at the abusive avoidance of tax —most especially schemes that rely for their "success" on less than full disclosure to SARS. We also appreciate that the State's battle against such schemes is not an

easy one, and that SARS and National Treasury constantly need to devise counter-measures to stem abusive tax leakage.

3.2 However, our concern is that overly broad and extreme counter-measures end up being counter-productive.

- As a general implication, it increases the cost of the tax system.

However, in the case of the 2011 proposals specifically, we are also concerned that:

- not only do they target unintended, purely commercial, transactions; but that

- they also run the risk of re-labelling straight-forward tax planning (that would ordinarily be considered to be simply "tax-efficient" or "tax mitigation"), as abusive or impermissible tax avoidance. The deep concern here is that a greater proportion of the SA taxpayer population will be treated as "offenders" purely because they are not paying more tax that the minimum that is required from them.

3.3 It is recognised that it is entirely appropriate that National Treasury should target abusive tax avoidance. However, we are concerned that the most recent proposals run the risk of extending the scope of what is considered to be "abuse" to include those who consider themselves to be "ordinary" taxpayers. (We intend to mention some examples of this risk in the detailed submissions below.)

3.4 It is also apparent that SARS and National Treasury have not obtained full factual information in relation to the abusive schemes of concern. The result has been numerous targeted anti-avoidance provisions introduced over the last few years which would appear to have been ineffective in addressing the schemes in question. Many of these anti-avoidance provisions have, however, impacted negatively on legitimate commercial arrangements. SARS has wide-reaching powers to obtain information under the various tax acts, including, where appropriate, powers of inquiry and search and seizure. It would appear that these powers have not been used to their full extent in terms of the schemes in question. It is inappropriate for further targeted anti-avoidance provisions to be introduced in the absence of SARS and National Treasury having obtained the information related to these schemes.

3.5 As we did last year, we again express our concern that it appears that the general anti-avoidance rule (GAAR) has yet to be invoked by SARS in relation to such schemes. The continued proliferation of targeted anti-avoidance provisions while the GAAR is ignored creates the impression that SARS are reluctant to invoke it and view it as an ineffective instrument.

3.6 Submission: Withdraw the anti-avoidance proposals that are so broad that they end up treating ordinary taxpayers as perpetrators of abusive tax schemes.

4. Proposals welcomed

4.1 Despite our primary focus in this letter on our concerns in respect of the new proposals, we do also wish to record our support for many of the initiatives contained in the draft Bill.

4.2 The proposals we applaud include:

- The additional rebate for persons over 75 years of age.
- The new source rules in s9 ITA.
- The confirmation of the tax treatment of contingent liabilities that are transferred upon the sale of a going concern business (s24CA).
- The CFC reorganisation rules in ss42-47.
- The deductibility of income protection contributions that are taxed as a fringe benefit
- The exemption for compensation received from the Road Accident Fund.
- The enhanced strategic industrial project incentives in s12I.
- The revision of the incentive regime for the film industry.
- The review of the "*living annuity*" rules and the introduction of the RIDDA ("*retirement income drawdown account*") provisions.
- The proposal to make the secondary transfer pricing adjustment discretionary (rather than automatic).

4.3 Naturally, the detailed analysis and practical application of these rules are expected to reveal additional areas for improvement and refinement. However, the very fact that these matters have been addressed is welcomed.

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Specific submissions

5. Suspension of Section 45

Draft Amendment Bill	Explanatory Memorandum ("EM")	Income Tax Act
Clause 75(1)(*b*)	Section 3.22	S45(6)(*a*)

5.1 The proposal to suspend the intra-group roll-over relief provision is inappropriate for (at least) the following reasons:

- The extent of the "abusive" transactions compared to the "legitimate" application of s45;
- The manner in which the suspension was imposed; and
- The deeper policy issue around interest deductibility.

The extent of the so-called "abuse"

5.2 Our own experience with the application of s45 is contrary to the assertion in the EM (on p75). According to the EM:

(a) The main application of s45 is *not* in accordance with its primary intended purpose —which was to "*facilitate transfers amongst member companies historically operating as a single group*" where those asset-transfers were "*funded by intra-group loan accounts*".

(b) Instead (according to the EM), s45 "*has mainly been used to facilitate leveraged buy-outs*".

5.3 However, our own experience in advising clients on applying s45 has been substantially different. Based on a very quick review of the s45 transfers that we have advised on in the first 5 months of 2011, i.e. until the suspension, we estimate that around 90% relate to transactions that are fully within the stated intention of s45 and that around 10% involved the application of s45 in acquisition deals. Admittedly, time constraints meant that we were not able to do more refined research to include the relative market values of these two categories.

5.4 We therefore re-emphasise the point that the complete withdrawal of s45 has in reality had the biggest effect on "ordinary" transactions that are not directed at tax avoidance.

The manner in which s45 has been suspended

5.5 First, we want to emphasise that s45 has indeed *de facto* been suspended. It is misleading to point to the fact that the suspension is currently simply a "proposal" contained in a "draft" Bill, and that there is still a possibility that the suspension will not be legislated. Rather, the fact that there is a clear proposal of an effective date (3 June 2011), and that National Treasury have in the past been successful with such retrospective effective dates, means that taxpayers are forced to treat the proposal as current law. Notwithstanding that the final promulgation of this

proposal might only occur in a few months time, it represents a significant (and generally untenable risk) for any group of companies to undertake any transaction on the assumption or hope that s45 will be available for transactions undertaken after 3 June 2011.

5.6 Secondly, the sudden, immediate and complete suspension of s45 has negatively affected business confidence. *Certainty* is a key requirement in instilling confidence in any economy, and sudden radical changes —such as the current suspension of s45— contribute to the kind of uncertainty that makes investors and entrepreneurs (local and foreign) see South Africa as a riskier environment.

5.7 Thirdly, we regret that the reporting requirement in s41(5) was not invoked, instead of the complete suspension of s45. Following the previous major debate (in 2008) on s45, s41(5) was specifically introduced to allay concerns around the potential future abuse of s45. S41(5) provides that "*The Commissioner may prescribe circumstances under which a person entering into* ... [for example, a s45 transaction] ... *must furnish a return to the Commissioner of that transaction* ...". It is noted that s41(5) was inserted on 22 July 2008 and deemed to have (retrospectively) come into effect on 21 February 2008 —but has, to date, never been used. It is therefore submitted that the concerns around specific categories of s45 transactions could have been subjected to a reporting requirement, instead of completely suspending s45.

5.8 As a fourth point, it is submitted that it is unfair to effectively hold the majority of "ordinary" taxpayers to ransom in pursuit of a minority of "abusers". It appears that one of the objectives of the suspension of s45 is to force taxpayers to disclose the tax-avoidance mechanisms that employ s45. With respect, it is submitted that most vendors of abusive tax schemes will *not* come forward and will instead set about devising alternative plans. These schemes are notoriously shrouded in secrecy and confidentiality. That said, even to the extent that this initiative is partially successful, it is submitted that it is inappropriate to use what is in effect a collective punishment mechanism to obtain information. SARS should rather invoke its wide information gathering powers to obtain this information.

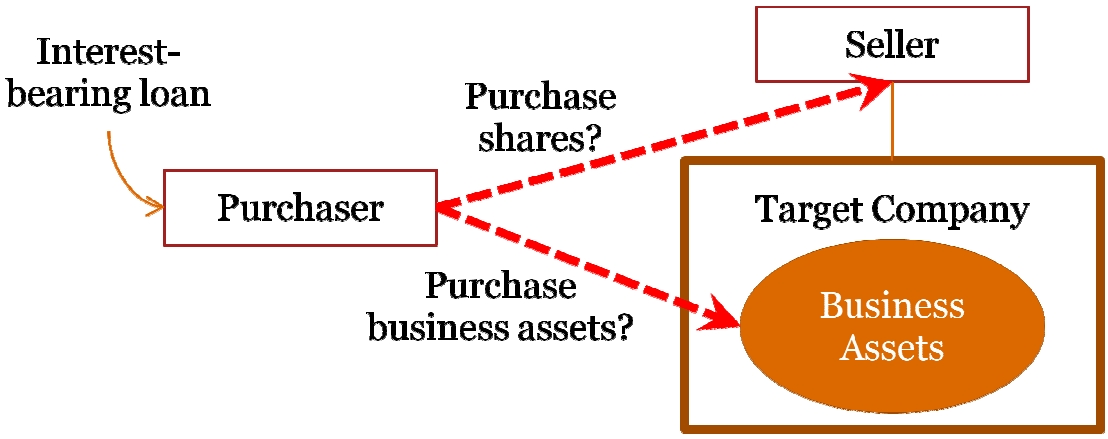
5.9 As a separate point related to the above, we express our concern that the perceived unfairness of this type of intervention runs the risk of alienating ordinary compliant taxpayers from the fiscus.

5.10 As a final point, it is noted that the Income Tax Act now seems to be proliferated with anti-avoidance measures all directed at preventing the same kind of abuse, i.e. the extraction of "excessive" interest. Examples include the s31 thin capitalisation / transfer pricing rules, the s45 "degrouping charge" which is supposed to monitor the utilisation of disposal proceeds, and the restrictions on the participation exemption for foreign dividends. It is submitted that the effective implementation of some of these measures would have reduced the need for such a radical measure.

The deeper policy issue around interest deductibility

5.11 As a separate matter, we would in any event question whether the facilitation of interest deductions in the context of debt-funded acquisitions (e.g. leveraged buy-outs) is truly objectionable —whether it involves the use of s45 or not.

5.12 The heart of the matter is that there is a perceived inequity in the SA tax system as regards the use of interest-bearing debt to fund the acquisition of business operations.



In the illustration above:

- If the purchaser buys the actual business assets, the related interest expenditure is deductible against the business income; but
- If the purchaser purchases the shares in the target business, SA tax law prohibits the deduction of the related interest expenditure.

5.13 However, from the purchaser's perspective, the interest costs of funding the acquisition represents a normal cost of doing business —irrespective of whether the shares or the business assets are acquired. It is that tax treatment that creates a distinction. SA taxpayers have for many years complained about the inequity of these rules, and this is exacerbated by the fact that foreign investors are generally accustomed to tax systems where it is the norm that interest expenditure is deductible against business income, irrespective of whether the purchaser buys the shares or the business assets.

5.14 In this context, the concept of a "debt push-down" is simply a mechanism to get the interest deduction and the operational income into the same entity —in order to reflect the true economic effect of the deal. We would add that this concept has traditionally *not* been considered to be overly aggressive or abusive —and it is of concern that the new proposals will now seek to treat affected taxpayers as "offenders". In fact, SARS has issued a number of favourable rulings that reflect their acceptance of this principle.

5.15 It is an undeniable fact that the post-acquisition interest relief that the purchaser will get in respect of its acquisition debt is a major consideration in determining the overall investment cost and return-on-investment. However, whilst there seems to be no objection to this fact in the context of asset-acquisitions, the current proposals have increased the level of confusion in the context of share-acquisitions.

5.16 Submissions:

- The proposal to suspend s45 should be withdrawn. As an alternative, a pre-approval should be required in respect of transactions funded with debt from sources outside the group of companies. Alternatively, the reporting requirement in respect of "suspect" transactions could be invoked.
- The policy in relation to interest deductibility (in respect of share acquisitions) and group taxation should be reviewed as a matter of urgency.

6. Re-characterising dividends and interest

Draft Amendment Bill	Explanatory Memorandum	Income Tax Act
Clauses 20 & 21	Section 3.25	S8E amendment, & New s8EA

6.1 The terminology used in this discussion includes the following:

- *Hybrid equity instruments and Third-party backed shares*: Where an investor invests capital into a company, but the tax rules (in effect) treat the investment as a loan. Thus the dividend income is treated as interest income.
- *Hybrid debt instruments*: Where a company borrows funds, but the tax rules (in effect) treat the borrowing as an equity investment received. Thus the interest payments are treated as dividend distributions.

6.2 The broad-brush re-characterisation of dividends into interest is another proposal that :
(a) is so broad that it attacks mostly non-abusive transactions; and
(b) sends a message that "ordinary" taxpayers are perpetrators of abusive tax avoidance.

6.3 The provisions in question adopt an economic substance over form approach to the treatment of amounts payable on the instruments. However, this approach is only followed insofar as one party to the arrangement is concerned. On the one hand, the investor (in the case of hybrid equity, for example) is treated as receiving taxable interest income as opposed to exempt dividend income. But on the other hand, the paying company (investee or borrower) is still denied any deduction for the payments made to the investor, i.e. still treated as having distributed dividends.

6.4 We are aware of a number of preference share funding arrangements where a funding entity is interposed between the ultimate recipient and the lender. In these cases, the intermediate

funding entity issues and invests in preference shares on a back-to-back basis. In these scenarios the choice of funding is *not* designed to produce any excessive tax benefit, but merely to ensure that there are no excessive tax costs that would have the funding too expensive to be viable. However, under the current proposals, the tax costs would be enormous as both the lender and the funding entity are subject to tax on the preference dividends accruing to them, but the funding entity obtains no deduction for the preference dividends paid by it. Ultimately it is the borrower who has to carry this tax cost as a result of the tax gross up clauses contained in any preference share funding arrangement. The result for the recipient in such circumstances is that the cost of funding is nearly doubled.

6.5 The extension of the period for hybrid equity and debt instruments to 10 years (from the current 3 years) will catch most if not all of these instruments. In our view, this sends a general message to all investors that almost all convertible or redeemable instruments are considered to be tax-avoidance tools.

6.6 Furthermore, if one follows the argument that certain share investments (e.g. preference shares) should be viewed as more akin to debt-funding, then one questions the consistency of extending the period to 10 years. That is, whilst it seems fair to assume that a 3-year redeemable instrument seems more like medium-term debt-funding (rather than long term equity), it seems inconsistent that a 10-year instrument should also follow the same reasoning.

6.7 In the absence of a deduction for interest on the purchase of shares, preference share funding is often used as a tax-efficient form of financing for the acquisition of shares. The proposed amendments to s8E and the new s8EA will effectively eliminate preference share funding as a viable alternative to debt. Many BEE transactions are funded through preference shares (either through third party funding or vendor funding) and the proposals are likely to render such transactions unviable as a result of the increased cost of funding. In many respects this makes a mockery of the concessions contained in s24B relating to cross-issues of shares introduced specifically to cater for BEE transactions.

6.8 A third-party backed share is defined so broadly that it will capture many commercial transactions which presumably are not intended to be caught by the provisions. For example, put and call arrangements are common in shareholders agreements and in BEE transactions. In the context of a BEE transaction, particularly involving private companies, a BEE partner may acquire ordinary shares with vendor finance. The holder/s of the other ordinary shares may have granted the BEE shareholder a right to dispose of the ordinary shares (or a portion thereof) at the time that repayment of the financing is due. In such circumstances, the ordinary shares would be third-party backed shares and any dividends accruing to the BEE shareholder would be deemed to be income and taxable in the hands of the BEE shareholder.

6.9 Furthermore, s8EA only deems dividends to be income in the hands of the recipient. The result is that such amounts would be subject to both income tax and the dividends tax. The same scenario arises with regard to s8E.

6.10 The proposed effective date is in respect of amounts flowing on or after 1 April 2012, irrespective of when the arrangements were entered into. This proposal is therefore effectively retrospective in nature in that it applies to existing instruments at that date. Taxpayers have a right to plan their affairs in accordance with the legislation in effect at the time and should not be subjected to burdensome amendments that have a detrimental effect on existing arrangements. In effect, National Treasury is proposing to change the rules of the game when it is already under way. Such retrospective legislation is arguably contrary to the rule of law and unconstitutional.

6.11 Submissions:

(i) The proposed amendments should be withdrawn.

Alternatively:

(ii) if a substance over form approach is to be adopted, the deeming provisions should apply to both the issuer and holder of the instruments; and

(iii) the proposals should only apply to arrangements entered into on or after the effective date.

7. CFC re-organisation rules

Draft Amendment Bill	Explanatory Memorandum	Income Tax Act
Clauses 72 – 77, & 124	Section 4.4	S41 – s47, & para 64B 8th Sch.

7.1 We applaud the decision to extend the corporate reorganisation rules to groups of CFCs. The ability to undertake the internal restructures within a CFC group is a necessary operation requirement. For example, following an acquisition it is established good commercial practice to review the acquired group of companies, and rationalise as appropriate to reduce ongoing costs or align the corporate structure to the operating model. This is no different from the approach that would be taken in the context of a domestic acquisition or group rationalisation.

7.2 It is also important to recognise that there are many drivers that create the need for a review and rationalisation of a corporate structure.

7.3 However, the proposed mechanisms for permitting corporate reorganisations require refinement.

7.4 From a practical perspective, in the context of a foreign merger, the proposals require the foreign CFC to understand the complex SA tax law in order to determine whether their rationalisation (in terms of their own domestic law) will qualify for the SA roll-over relief.

7.5 The requirement in s44(4) that consideration in the form of either equity shares or the assumption of certain categories of debts, will often prevent the application of this relief in the context of a foreign merger.

7.6 We are unsure as to the reason why there is a 95% group requirement, since in the context of inter-CFC transactions, there is no loss to the fiscus as the assets/operations remain within the CFC provisions, and therefore, the SA tax net. This is particularly relevant in the context of the proposed deletion of the inter-CFC participation exemption —discussed further below.

7.7 The requirement that the amalgamated company must cease to exist after the amalgamation, conversion or merger, could be problematic if that is not the way that transaction would take place in terms of the foreign law.

7.8 In short, these issues would not arise if, in line with existing precedent, the SA legislation simply referred to "amalgamation transactions" without adding the further requirements discussed above.

7.9 As a separate matter, the removal of the inter-CFC participation exemption in para 64B(2)(*b*)(iii) means that any inter-CFC transfer that does not qualify for the reorganisation relief, will trigger a tax charge when it is very likely that the SA CFC group would not have realised any proceeds. This is contrary to the fundamental principle of ability-to-pay.

7.10 Submission: Remove the requirements for a 95% group, the termination of the amalgamated company, and the consideration restrictions in s44(4) in respect of foreign amalgamations.

8. Foreign dividend exemption

Draft Amendment Bill	Explanatory Memorandum	Income Tax Act
Clause 32.	Section 3.20	S10B(4)(*c*)

8.1 The so-called participation exemption offers an exemption for the repatriation of foreign dividends where the SA-resident shareholder owns at least 20% of the foreign company. This is an established and relied-upon exemption in SA, and follows an established international model (particularly throughout Europe and more recently adopted by the UK).

8.2 First, we applaud the decision to reduce the qualifying threshold to 10%.

8.3 However, we remain concerned about the so-called FFIHC ("*foreign financial instrument holding company*") provision. The requirement that the foreign companies must first pass the

FFIHC test (before the exemption can apply) is far too onerous in practice, and will effectively freeze distributable reserves in the foreign declaring company.

8.4 In practice, there are SA multinational groups with literally hundreds of foreign subsidiaries, and this provision represents a real impediment to cash repatriation into SA, as well as general international competitiveness. As far as we are aware, SA's treaty partners do not have a similar rule.

8.5 We understand the rationale for the proviso to be essentially aimed at preventing SA tax base erosion. Accordingly, we request that consideration be given to specific avoidance measures that will disallow the deduction at source, rather than preventing the dividend exemption through the use of an unmanageable test.

8.6 Submission: The FFIHC test in the current s01(1)(k)(ii)(dd) *proviso* (iii) (proposed to be replicated into th new s10B(4)(*c*)), should be withdrawn. Instead, it is suggested that there should be a specific anti-avoidance provision which disallows the deduction at source.

9. Removal of Value Extraction Tax ("VET")

Draft Amendment Bill	Explanatory Memorandum	Income Tax Act
Clause 91	Section 3.16	Part IX of Chapter II

9.1 VET refers to the new tax that was expected to be implemented together with the new Dividends Tax on 1 April 2012. Whereas the Dividends Tax will be a 10% tax on "actual" dividends, the VET was expected to raise a 10% tax on "deemed" dividends (or what would have been known as "value extractions"). This is similar to the "deemed dividend" rules that exist under the current STC regime.

9.2 There is now a proposal to delete the VET as a separate tax, and to rely instead on an extended definition of what constitutes a "dividend". In summary, the types of transactions that are currently considered to be "deemed" dividends could in future be included as "actual" dividends and this will be subject to the 10% charge under the normal Dividends Tax rules. The proposal is to, amongst others, replace the existing reference (in the "dividend" definition) to "*by virtue of any share held*", with the term "*in respect of any share held*".

9.3 However, the proposed reliance on the term "*in respect of any share held by that person*" will lead to significant uncertainty. The term "*in respect of*" does not have a meaning materially different to "*by virtue of*". As such, it is unlikely that the mere substitution of these terms will have any impact on the interpretation of the dividend definition.

9.4 Furthermore, it has been held that the term "in respect of" does not always cover a loose association but must in some cases be limited to close or more direct associations. The expression can be used in various senses and it is necessary to examine the context to ascertain in which sense it is used. There is therefore no certainty that the term as used in the dividend definition will be interpreted in such a way that it will cover a wide range of association.

9.5 Adding to this is that the dividend definition refers to amounts transferred or applied by way of a distribution or as consideration for the acquisition of any share in that company. This seemingly limits the reach of the dividend definition to amounts transferred or applied in such manner. Arguably, this would mean that amounts transferred or applied in the form of, for example, a loan or waiver of a debt would not fall within the definition of a dividend regardless of whether such loan or waiver may have had some causal connection to a share.

9.6 Furthermore, the dividend definition will require that the amount transferred or applied be for the benefit "*or on behalf of*" any person in respect of any share held by that person. Where the benefit is given to a person who is not a shareholder in the company, the amount would arguably not be a dividend as defined. In such a scenario, the second example in the draft EM would be incorrect as the payment to the son would not be for the benefit or on behalf of the shareholder.

9.7 Leaving the interpretation of the expression to the courts to apply an interpretation "in light of the statutory purpose and intention" is unsatisfactory as it leads to lack of certainty and potential increase in disputes. It has consistently been stated that one of the cornerstones of good law is clarity —and the proposed change removes rather than provides clarity.

9.8 Submission: the removal of the VET should be reconsidered. At best it will result in significant uncertainty and at worst open substantial loopholes for value extractions. Alternatively, a more specific term needs to be used to broaden the connection between a value extraction and the share for example "as a direct or indirect result of any share" and the dividend definition broadened to cover a wide range of transfers of value and persons covered.

10. Debt without specified maturity dates (Perpetual debt)

Draft Amendment Bill	Explanatory Memorandum	Income Tax Act
Clauses 23 & 57	Section 3.24	S8G & S24J

10.1 This refers to the proposal that where a debt instrument has no specified repayment date, the interest payments will be deemed to be dividends. This means that the borrower will not be permitted to take a deduction for payments made, and the lender will be subject to Dividends Tax on the payments received.

10.2 The proposed "perpetual instrument" provisions of s8G are extremely wide-reaching and would have consequences far beyond the circumstances apparently intended. For example, the provisions apply regardless of whether or not the issuer of the instrument is a company. The result is that where the issuer is, for example, a natural person, the interest on a perpetual instrument would be deemed to be a dividend declared by a natural person. This is a patently absurd result.

10.3 The definition of a perpetual instrument is couched in such wide terms that it would cover, for example, bank overdrafts in addition to many shareholder loans. We submite that it is illogical to afford quasi-equity treatment to debt arrangements between third parties.

10.4 The proposal to deem interest on perpetual instruments to be dividends will have a huge negative effect on the real estate investment industry. Property loan stock companies are structured and financed in the form of linked units where shares and debentures are linked and trade as a single instrument on the JSE. The rights of the debentures are such that all or most of the operating profits of the companies are paid to unit holders in the form of interest on the debentures. In general, these debentures do not have a specified maturity date, but are redeemable after a specified date at the option of the unit holders by way of special resolution and on significant notice (usually 5 years). These debentures will all be perpetual instruments as defined in that they do not specify a maturity date. The result is that the property loan stock companies will all face significant tax liabilities and dividends tax withholding obligations and the proposal will significantly reduce the returns enjoyed by investors in these companies.

10.5 The proposed effective date of s8G is in respect of amounts paid or incurred on or after 1 April 2012. This proposal is therefore effectively retrospective in nature in that it applies to existing instruments at that date. Taxpayers have a right to plan their affairs in accordance with the legislation in effect at the time and should not be subjected to burdensome amendments that have a detrimental effect on existing arrangements.

10.6 Furthermore, s8G(2) provides that "*any amount*" paid or incurred by an issuer in terms of a perpetual instrument is deemed to be a dividend. The effect is that a repayment of the *capital* is also deemed to be a dividend and not only the interest component.

10.7 Submissions:

(i) s8G should be limited to instruments where the issuer is a company and, furthermore, where the holder is a "*connected person*" in relation to the issuer-company.

(ii) The effective date should be in respect of instruments issued on or after 1 April 2012 and not in respect of amounts paid or incurred on or after that date.

(iii) Submission: the payments deemed to be dividends should be limited to payments of interest.

11. Headquarter companies

Draft Amendment Bill	Explanatory Memorandum	Income Tax Act
Clause 29	Section 4.10	S9I

11.1 The proposed requirement for a company to apply for approval to be treated as a headquarter company is problematic for a number of reasons:

- The requirement is administratively burdensome.
- An approval is "for a year of assessment" and therefore requires approval to be renewed on an annual basis.
- The criteria to be considered by the Minister are subjective and, in some instances, not appropriate given the nature of the tax relief afforded to headquarter companies. In particular, the requirement that the granting of the approval will lead to the creation of additional skills or related intellectual infrastructure is not appropriate. In reality, the regime offered by SA is not a "headquarter" company regime, but a "holding" company regime as no additional incentive is provided for *management* to be located in SA —any income of the company being fully subject to corporate income tax.
- Headquarter companies are in any event subject to an annual reporting requirement.

11.2 Submission: The criteria to qualify as a headquarter company should be solely objective and companies should have the option to elect for the regime to apply. Given the concerns related to these companied being used to erode the SA tax base, it would be more appropriate for the power to be provided to the Minister to withdraw the application of the regime on a case-by-case basis, rather than to require pre-approval.

We trust that you find the above to be of assistance.

Yours sincerely,

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