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Mr Allan Wicomb
Standing Committee on Finance
Parliament

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Dear Allan

The Draft Taxation Laws Amendment Bill 2011

The Draft Taxation Laws Amendment Bill 2011 ("TLAB"), together with the Explanatory Memorandum ("EM"), which were released for comment on 2 June 2011, contain provisions which have the potential to dramatically affect the Financial Services market, in particular the Banking Industry, in South Africa.

This paper contains the Banking Association of South Africa's ("BASA") position regarding the most pertinent proposed amendments. BASA's comments in relation to the other proposed amendments will be contained in its comprehensive submission to National Treasury, due by 5 July 2011.

It appears that National Treasury is attempting to introduce legislative amendments aimed at isolated cases of abuse in a broad based manner which will have detrimental implications for legitimate commercial transactions and does not seem to have been properly considered by National Treasury. Further, the impact of the amendments on current transactions without any grandfathering of these transactions and then potential retrospective application is problematic.

An overriding principle overlooked and not properly addressed in the TLAB is that any direct tax on dividends, strictly speaking amounts to a double tax on profits with no corresponding deduction for the company payor.

The major proposals are largely focussed on perceived abuse that has resulted in the undesirable deduction of interest. This is perceived to be facilitated from commerce's perceived ability to manipulate debt and equity instruments. Debt or equity instruments are favoured for specific and valid commercial reasons. Theoretically, in a confined environment and subject to certain exempt entities, no single instrument, whether classified as debt or as equity, should destabilise the tax base, if the tax law is correctly applied. This is so on account of what normally is taxable in the one

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taxpayer's hands would be tax deductible in the other and what is exempt would ordinarily not be deductible. It should therefore be irrelevant whether taxpayers favour one instrument above the other.

1. ANTI-AVOIDANCE: SUSPENSION OF INTRA-GROUP ROLLOVERS

The amendment to section 45 of the Income Tax Act, No. 58 of 1962 ("the Act"), as proposed by clause 75 of the draft TLAB and discussed in paragraph 3.22 of the EM, refers.

1.1. Problem statements

The suspension of section 45 has a potentially catastrophic impact on taxpayers as various restructures which were planned for months have now had to be placed on hold with no forewarning from National Treasury or SARS. There was no mention in the National Budget Speech in February 2011 that National Treasury or SARS were considering the future use of section 45 or that they had concerns regarding its abuse by taxpayers. To the extent that taxpayers are still required to continue with a proposed restructuring which is a genuine internal re-organisation, as opposed to the use of section 45 to facilitate an acquisition with excessive debt characteristics, the cost may be substantial in the absence of group relief, including the wasted costs of suspended transactions.

We submit that National Treasury should refrain from using a "broad brush" approach to put an end to potentially tax aggressive transactions, being to a large degree, the so called 'funnel financing" schemes, as this, in our view, undermines legitimate business activities and is patently unfair to "compliant" taxpayers, such as an internal group restructures. This action will also have a serious negative impact on foreign investors wanting to invest into South Africa, as "business environment certainty" is a key factor to foreign investors. Foreign investors who have been considering transactions in South Africa may re-evaluate their investment plans, since foreign business does not wish to operate in an environment where the legislature can create laws that have a material impact on their investments without any advance warning. The negative impact on the South African economy should be weighed against the benefits to be achieved by forcing parties to the 'disclosure table' as indicated by National Treasury. This has already has a negative impact on the South African economy, as is evidenced by the announcement on 7 June 2011 that the proposed buy-out of computer distributor Mustek has been called off due to the uncertain impact of the suspension of section 45 on the transaction. The Mustek share price fell almost 12% after the announcement. Announcements of this nature borders on irresponsible behaviour.

We note that the funnel financing issue was initially raised in 2008 with National Treasury issuing a warning regarding its intent to clamp down on funnel financing transactions. Since then, more than three years have elapsed without

any attempt on the part of National Treasury to curb these perceived aggressive tax practices. Suspension of the application of section 45 with immediate effect to allow National Treasury time to consider the provisions seems unreasonable and grossly unfair to the significant majority of taxpayers relying on this provision, without being involved in tax-sensitive M&A or funnel financing activities. At the very least, National Treasury should provide taxpayers with advance notice of its intention to take such drastic steps.

It should furthermore be borne in mind that many Black Economic Empowerment ("BEE") transactions have historically necessarily been concluded based on the application of the provisions of section 45. The suspension of section 45 would no doubt force parties to consider alternative structures so as to minimise the tax impact of introducing BEE partners into a business. Given that the suspension of section 45 is likely to lead to potential excessive tax costs, we are certain to see a reduction of the number of BEE transactions being concluded, and those that do proceed without the ability to utilise section 45 will potentially lead to a significantly increased cost to the BEE parties and potentially jeopardise the future viability of these transactions. These proposed changes may be seen as untimely at best as commerce in South Africa is trying its utmost to comply with the charters as set down by government – especially transferring ownership.

1.2. Proposed solutions

We contend that since National Treasury has admitted to pursuing this suspension to force disclosure of the "good" and "bad" section 45 deals, it should urgently meet with all affected parties, to clarify the nature of the latter, and, if the existing general anti-avoidance provisions contained in section 80 are deemed insufficient, design specific anti-avoidance provisions to deal with the true problem.

2. ANTI-AVOIDANCE: PROPOSAL TO TAX CERTAIN DIVIDENDS

The amendment to section 10(1)(*k*) of the Income Tax Act, as proposed by clause 30(1)(*n*) of the draft TLAB and discussed in paragraph 3.23 of the EM, refers.

2.1. Problem statements

2.1.1. Objectives of the proposed amendments

It is clear that many of the proposed amendments are an attempt to put an end to some of the largest and most widespread wholesale tax arbitrages, in relation to certain dividend income funds.

Within this context, we believe that the proposed amendments need to be measured against four overarching points:

- Do these amendments result in unintended consequences?
- Can these amendments be practically implemented and at what cost?
- There should be parity between taxability of income and concomitant deductibility as well as fair and equitable tax treatment for all market participants so as not to artificially distort the competitive environment.

These amendments should reinforce government's strategic vision for South Africa, which includes South African capital markets playing a pivotal role as the gateway to Africa. We are concerned that these amendments would not only negatively affect the liquidity of our listed equity markets, but will encourage the shifting of transactions to such markets in other countries.

- ***Anti-avoidance legislation***

  From a policy perspective it is unclear why specific anti-avoidance legislation has to be introduced to prevent the dividend exemption from being applied in the case of many conventional activities, including securities lending and certain share trading activities. Current tax law already provides for the non-deductibility of expenses incurred to earn exempt income. There is thus no need for these additional measures.

2.2. Proposed solutions

We recommend that before a blanket measure of this nature is introduced, NT and SARS should more clearly explain why the existing legislation is insufficient to remedy the problems that concern them.

3. ANTI-AVOIDANCE: DEBT WITHOUT SET MATURITY DATES

The introduction of section 8G of the Act, as proposed by clause 23 of the draft TLAB and discussed in paragraph 3.24 of the EM, refers.

3.1. Problem statement

Debt and shares are both used as funding instruments. However, they have very distinct characteristics and economical results. In certain transactions the one instrument might be favoured above the other. For example, preference share funding is typically favoured for the financing of equity acquisitions in BEE transactions. In other instances, debt would be structured to closely resemble characteristics of equity to achieve certain commercial results. In both cases, tax is, at most a secondary consideration.

There is grave concern amongst BASA members that Tier 1 Hybrid-Debt instruments ("Hybrid-Debt") issued by banks will be affected by the proposed

section 8G of the Act and that this measure will also affect other ordinary shareholders and intergroup debt with no specific maturity dates. Hybrid-Debt, as derived from BASEL II guidelines, is regulated under Regulation 38(13), issued in terms of section 90 of the Banks Act.

Hybrid-Debt typically has no maturity date and is structured to display certain characteristics of shares in order to rank as Tier 1 capital for purposes of the Banks Act, but does not physically become equity. It appears that these amendments would apply to any payments made after 1 April 2012 on debt already in issue before that date. This is also biased in the sense that interest incurred on debt currently in issue for purely commercial purposes would become non-deductible after this date. BASA believes that it would be highly unjust if Treasury deems interest on Perpetual Debt to be non-deductible where such debt has already being issued. The pricing of these instruments was based the applicable income tax legislation at the time. These amendments would be in direct conflict with the newly introduced concepts of contributed tax capital and dividends. BASA submits that National Treasury's view that Perpetual Debt is essentially equity is incorrect and possibly demonstrates a lack of understanding of the concept. The Banks would typically issue Perpetual Debt (e.g. Hybrid-Debt) to improve their capital adequacy ratios from a Banking regulatory perspective. Hybrid-Debt is in all respects debt, but attains a Tier one capital rating from a BASEL II perspective. Equally and importantly, the recipient is subject to income tax on the interest, ensuring and maintaining tax neutrality. Exempt entities have been granted exemption for specific fiscal and economic reasons. This should therefore not detract from the principles discussed above.

We trust that it was not the intention of National Treasury to prejudice Banks in relation to Hybrid Debt and kindly therefore request clarification on this point.

2.3. Proposed solution

Our recommendation is that to the extent that the redemption date of perpetual debt cannot be reasonably estimated for the purposes of the amended section 24J, a cap could be considered. Alternatively, a 'carve out' for Hybrid-Debt should be considered, subject to SARS approval (there shouldn't be many of these instruments since the use thereof is restricted to a few institutions).

4. ANTI-AVOIDANCE: THIRD-PARTY BACKED SHARES

The introduction of section 8EA of the Act, as proposed by clause 21 of the draft TLAB and discussed in paragraph 3.25 of the EM, refers. In addition, the amendment to section 8E of the Act, as proposed by clause 20 of the draft TLAB and discussed briefly in paragraph 3.25 of the EM, refers.

4.1. *Problem statements*

The introduction of section 8EA of the Act, which introduces the concept of 'third party backed shares' is a far reaching piece of anti-avoidance legislation which goes to the very root of equity financing. The intent of National Treasury to view the concept of debt and equity on a substance basis, with a view to denying interest deductions and taxing income streams of equity, is misguided and ignores the legal characteristics of each, which is the fundamental basis of our income tax system. Financial services utilises numerous complex instruments which have sound commercial application, which is wholly overlooked in terms of the latest proposed amendments in relation to preference and other equity shares.

It is noted in the EM that a tax incentive may exist for a taxpayer to attach a label to a debt or share instrument that differs from the underlying substance. The inference is that this results in an erosion of the tax base. In this regard, whether debt displays equity characteristics or equity displays debt characteristics, the legal nature is not changed and the possession of these characteristics is indifferent to any tax base considerations. From a generally accepted accounting point of view, a redeemable instrument is classified as debt because of the redemption feature. However, the accounting classification has no relevance to the legal classification of the share. From a legal perspective, the share remains subordinate to any form of debt (including subordinated debt) and remains equity i.e. on a liquidation it ranks behind all forms of creditor. Because the preference share is subordinated to debt, funders endeavour to obtain security. The use of any form of security structure does not impact on these equity fundamentals and in fact confirms the equity nature of the instrument from a legal perspective. These security structures in themselves do not cause any imbalances and do not disturb the tax neutrality. The mitigation of pure equity risk, in itself, does not lead to any erosion of the tax base. The dividend paid by the issuer is not deductible whilst the dividend that accrues to the holder is not taxable. Tax symmetry is still achieved. It is submitted that this is especially so in the Banking Industry, where preference shares are generally funded from 'after tax' money. In other words, where preference shares are funded out of the capital reserves of a Bank, i.e. share capital and retained income, there is no interest deduction for the Bank concerned.

The proposed amendment to section 8E of the Act appears to be exceedingly short sighted since the funding provided by preference shares is a valid mechanism for funding the acquisition of equity or other transactions unproductive of income (as defined) on a tax neutral basis. There is also no justification provided for arbitrarily amending the 'safe harbour' period from 3 years to 10 years. In fact, a term of 10 years resembles equity rather than debt, in which case there should be no anti-avoidance provisions. Whether a preference share is issued for 3 years or 10 years will not change the legal characteristics of the preference share and it is difficult to see what mischief

this would counter. It is exceedingly difficult for the creditworthiness of a client to be ascertained on a 10 year basis.

The current wording of section 8EA of the Act appears to implicate all shares, including equity shares, and not just preference shares. This is contrary to the comment on page 81 of the EM in this regard that the section should not affect equity shares. There are numerous apparently unintended consequences of this wide application of the new section.

Section 8EA(d)(ii) of the Act will impact all instances where equity is provided as collateral for any lending transaction. This will affect all BEE deals, private bank lending and corporate lending, as well as the derivatives market. It will also affect equity shareholders of private companies. It is not clear if National Treasury intended this.

The majority of BEE deals in this country have been funded via preference shares. Initially the BEE parties have very little equity to contribute to the transaction, so other financial support is granted by the empowered company. Again under S8EA these will become taxable. This significant resultant tax cost will be passed back to the issuer of the preference shares and the result is that many of these deals which were previously able to grow at a rate in excess of their cost of funding and create value for BEE parties, will no longer be able to do so. The introduction of the proposed amendments will make funding of BEE structures through preference shares untenable with the resultant funding of these transactions through debt resulting in the increased cost having a significantly adverse impact on the ability of parties to fund these transactions and where this is feasible, a significant increase in the funding period with resultant detrimental impact on empowerment parties.

4.2. *Proposed solutions*

At the very least, the proposed amendment to section 8E of the Act should be only be effective in relation to 'hybrid equity instruments' issued after 1 April 2012, with the previous provisions of section 8E remaining effective in relation to such instruments issued prior to 1 April 2012. The proposed 10 year restriction on these types of section 8E instruments needs to be revised since 10 years resembles equity rather than debt, in which case there should be no need for an anti-avoidance provision. National Treasury is urged to engage with the Banking Industry regarding the far reaching, and arguably unintended, implications of all equity shares being implicated in this regard, since there is a potential of seriously affecting the derivatives industry in South Africa. An alternative is to define a 'third party backed share' to exclude equity shares, alternatively include equity shares with at least one debt type characteristic, thereby leaving normal listed and unlisted equities outside the scope of this section.

Regarding the shares which National Treasury actually intended to include in this new section, the criteria included in the issuing of directives should be

incorporated into the legislation going forward on an exemption basis, rather than being available only in respect of shares issued before 1 April 2012, i.e. if the shares already in issue would qualify for relief, then the same shares should qualify for relief going forward. Arguably, this relief should also be granted to section 8E instruments, i.e. where such instruments are funded out of capital, where there is no interest deduction, then the dividends should not be taxable. It is recommended that either a carefully drafted exemption be included in both sections 8E and 8EA of the Act, alternatively that a ruling based system be introduced whereby SARS may review the shares to be issued (whether they are 'hybrid equity instruments' with terms less than 10 years and no collateral, or equity shares with collateral) and issue a directive regarding the taxation of their dividends going forward, provided that the Commissioner is satisfied that there is parity in tax treatment, i.e. the dividends are not derived from financial instruments in respect of which a deduction may be claimed and that the South African tax base is not eroded as a result of the transaction.

In the event that National Treasury does not agree with any of the recommendations above, then we urge that National Treasury reconsiders allowing a deduction for interest on debt incurred to acquire shares. If the dividends on shares in most instances (and given the overarching and wide application of the anti-avoidance legislation regarding dividends) are taxable without any consideration for the funding thereof, then parity is sought in relation to the funding thereof, i.e. interest on the acquisition of shares should be deductible and companies should be allowed to deduct dividends to shareholders.

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