APPENDIX A

Long-term insurance: Contributions as a fringe benefit (EM 2.3)
Tax Bill: Clauses 110 and 113
Tax Act: Paragraphs 2(k) and 12C of the Seventh Schedule

1 Whilst there can be no issue with the proposed change to ensure employer contributions from which the employee may ultimately benefit being treated as taxable fringe benefits, an issue does arise in respect of the proposed effective date of 1 January 2011 as currently framed.

2 Whilst the EM refers to the proposed changes applying to premiums incurred during any year of assessment commencing on or after 1 January 2011 (though it is not clear whether the year of assessment would be that of the employer or the employee with the two often differing) the related clauses in the draft Bill contemplate application to premiums paid on or after 1 January 2011.

3 The retrospective nature of the change in this regard is not only negative on taxpayers (contrary to a general undertaking by Treasury not to act in this way) but in this instance is likely to impact on the tax year ended 28 February 2011 for which employers will already have completed have completed the IRP5 returns.

4 This degree of retrospectivity simply cannot be supported as it opens up employers (and taxpayers) to potential interest and penalties as a result of something over which they had no control or knowledge.

5 As a separate point, with regard to the proposed allocation methodology in the proposed paragraph 12C(2), we question whether a pro-rata split based on number of employees is a good starting alternative in the absence of direct allocation. Surely an allocation based on an individual's salary cost as a factor of the total salary cost would give a better indication and reduce the risk of any attempt to morph the tax benefit of high taxed individuals into those of lower taxed individuals?

Submissions

- **The effective date for the changes should be amended to apply only to premiums incurred on or after 1 March 2011 (the start of the individual employee's year of assessment).**
- **The starting (alternative) methodology in the proposed paragraph 12C(2) should be by reference to an employee's salary as a percentage of the total salary cost to the employer.**

Dividends from Employee based schemes (EM 2.7)
Tax Bill: Clauses 7(1)(h) and 30(1)(m)
Tax Act: Section 1 and the proposed section 10(1)(k)(i)(dd)(C)

We refer firstly to our comments in our covering letter as to the need to pursue equitable legislation and in this case to the principle that should section 10(1)(k)(i)(dd) apply to treat dividends in respect of restricted equity shares as, in effect, hidden salary, then it is only equitable that the treatment in the paying company should be adjusted to treat that payment as deductible salary cost and not subject to either the current secondary tax on companies or the proposed dividends withholding tax.

We would also repeat that point we made last year that the Seventh Schedule should be amended to ensure that payments made by a company to which s10(1)(k)(i)(dd) applies should be subject to PAYE at the time of payment.

Turning to the position of the recipient, it would appear that the proposed insertion of section 10(1)(k)(i)(dd)(C), the exception to the denial of the exemption, at clause 30(1)(m) is wholly negated by the proposed insertion of paragraph (b) to the definition of 'dividend' by clause 7(1)(h).

The proposed paragraph (b) of the 'dividend' definition in section 1 requires that for an amount to be a dividend it must be in respect of a share held by a person. This will not apply where a person is the beneficiary of a trust (such as an employee share trust) with the trust holding the share. In such instance the receipt of a distribution by the trust of a dividend received by the trust would fall outside the dividend definition even prior to any potential application of section 10(1)(k)(i) or the exceptions thereto.

In this regard it is not clear from the language in the definition of 'dividend' whether the 'and' after subparagraph (cc) of paragraph (a) means that for a payment to be a dividend both the requirements of paragraphs (a) and (b) must be met or if the two can be said to operate independently. We would suggest that given the operation of the exemptions in section 10(1)(k)(i) the latter is probably the correct application, i.e. that a payment by a company can still be a dividend by the company even if it is not a dividend in the hands of the recipient. We would however suggest that the language be amended to clarify this.

Related matter

If our interpretation above is correct, ie that for a 'dividend' to remain so the party receiving the dividend must hold the share (per proposed para. (b) of definition) the impact extends beyond employee trusts and would impact on, for example, all family trusts also, denying the exemption for distributions of profits that have already been subject to tax. Indeed this seems to be the proposition put forward as evidenced by the narrative on page 78 of the EM.

If so this is simply astounding and represents a substantial departure from the long-standing position under South African tax law. We would go further and state that, in the context of trusts established as wealth protection or security vehicles (both established for legitimate commercial purposes) this is a dangerous and unprincipled proposal. There is no basis for levying what amounts to double tax in these circumstances where the company making the dividend payment has already been subject to the normal rate of tax (and potentially the secondary tax on companies) and, going forward, where the recipient has already borne the dividends withholding tax.

To apply a blanket denial on dividend exemptions where a trust is simply used as a holding vehicle (ie the trust, and indirectly therefore its beneficiaries, does have a meaningful economic stake in the underlying shares) and none of the issues which appear to concern Treasury (eg dividend cessions per 3.23 of the EM where the comment as to trusts is made) apply is simply not justifiable.

Submissions

- **The interaction between paragraphs (a) and (b) of the 'dividend' definition should be amended so as to clarify whether they are intended to operate on a cumulative basis or not;**
    - **If they are intended to operate on a cumulative basis additional clarity is required as to what the nature of the payment then is from the paying company's perspective is where para (a) is met but para (b) not.**
- **Paragraph (b) of the 'dividend' definition requires to be amended in respect of interests in trusts so as not to render the relaxation of s10(1)(k)(i)(dd), through the introduction of paragraph (C) thereto, meaningless with the result that all dividends flowing through employee share trusts would be taxable.**
- **Where exemption is denied a taxpayer by reason of section 10(1)(k)(i)(dd) the payment by the company should qualify for a deduction as salary (subject to all other normal requirements being met) and should not be a dividend for purposes of either the secondary tax on companies or the dividends withholding tax.**
- **Dividends should not lose their exempt status simply by virtue of having been first received by a trust and then distributed to a beneficiary (whether vested or discretionary).**

Asset for share transaction with excess liabilities (EM 3.3)
Tax Bill: Clause 73(1)(l)
Tax Act: Section 42(8)

The changes proposed are, per page 35 of the EM, aimed at reducing the base cost of assets acquired in terms of a asset for share transaction by an amount equal to the debts assumed by the acquiring company. However we are concerned that in fact the 'rollover relief' will in some instances result in upfront taxation (ie not even a deferral).

By way of example, if a property held on capital account is transferred to a company in return for shares, with the property having a market value of R3m, a base cost of R1m and securing debt of R1.5m, it would appear that a gain of R500k in respect of the 'excess debt' will arise as the base cost can only be reduced by R1m.

Where the property is held on revenue account the position is even less clear, with the possibility existing that the full face value of the debt (R1.5m in our example) could be subject to tax without any offset against the tax cost of the asset (there still having been no disposal of the shares acquired).

It is submitted that either of the above consequences would be a wholly in appropriate result for what is intended to be a relieving mechanism to facilitate corporate reorganisations (per Treasury's presentation to the SCoF on 15th June these are to be supported as, *inter alia*, promoting competition).

It is submitted that the correct answer would be for the tax basis in the asset (whether held on capital or revenue account) to first be reduced to the full extent possible with any excess then added to the proceeds on a later disposal of the shares.

It must be remembered that the reorganisation provisions in section 41 to 47 are a departure from the normal base rules and accordingly there should be no need to align them fully with the base rules as this can never truly be the case.

On a separate note, and as referred to in our opening comments as to existing inequity within the tax system, we would submit that the doubling up of tax exposures under section 42 should be removed.

If party A currently holds an asset with a market value of R10m and a base cost of R5m and transfers this to Party B in return for shares worth R10m, under section 42 the closing position is that party A now holds shares worth R10m with a base cost of R5m and party B holds the original asset worth R10m with a base cost of R5m.

It is thus immediately evident that the gains potentially subject to tax have doubled up, both Party A and Party B now both have a potential taxable gain of R5m.

This is much worsened by the proposed removal of section 45. None of sections 45, 46 or 47 involve such a doubling up in provisions which are intended to be relieving mechanisms. Section 45 gives a step-up on one leg of the transaction whilst each of sections 46 and 47 disregard the relevant disposal whilst applying roll over base cost to the revised asset. It is not clear on what basis Treasury considers that section 42 should justify a doubling of the tax exposure.

Submissions

- **The proposed amendments to s42(8) should be limited to giving proceeds only to the extent of existing tax basis.**
- **Clarity is required as to what, if any, offset is available in respect of a return of capital contemplated in s42(8)(bb) where a share is held as trading stock – it is not immediately apparent that a taxpayer can obtain any deduction against such inclusion by reference to their cost of shares.**
- **Section 42 should be recast so as to avoid the doubling up of tax exposures in what should be exclusively a relieving set of provisions.**

Single exit charge for emigration (EM 3.4)
Tax Bill: Clause 28
Tax Act: Proposed section 9H

The proposed single exit charge is welcomed both from a simplicity perspective and from an equity perspective in avoiding, in the case of companies, the need to seek taxation of dividends from the shareholders when they receive no distribution.

However we would highlight that a deemed disposal at market value inevitably results in a gain which is greater than would be realized under an actual disposal at the same market value. With an actual disposal the taxpayer would inevitably incur costs associated with the disposal and we submit it is only fair that provision be made for a deemed deduction from market value in arriving at the amount to be subject to tax.

Submission

Provision be made for the allowance of an amount (e.g. on a sliding scale of fixed amounts per value of asset) of the market value of an asset to be deducted from the market value as representative of the costs of disposal which would have been incurred had the asset actually been disposed of.

Assumption of contingent liabilities: taxable company acquisitions (EM 3.5)
Tax Bill: Clauses
Tax Act: Sections 1, 11F, 24CA, 42, 44, 45 and paragraphs 20(1)(a) and 35(1) of Eighth Schedule

The proposed changes are welcomed in terms of providing certainty as to the tax treatment.

However, whilst their impact has been factored into section 42 (through the insertion of s42(3A)(c) and the amendments to s42(8)) we note that no equivalent amendments have been made to either sections 44 or 45.

Section 44 should also be amended in this regard, as should section 45 on the basis that it will be retained (separate discussion in this below).

Submission

Sections 44 and 45 should be amended to cater for the assumption of contingent liabilities in the same manner in which section 42 has been updated.

Debt cancellation (EM 3.11)
Tax Bill: Clauses 7(1)(n)
Tax Act: section 1 (definition of 'gross income')

Whilst the EM refers to only "certain forms of debt reduction or discharge will trigger gross income treatment", this concept does not appear to have been carried over into the legislation.

Despite the EM stating that reductions or discharges will no longer be viewed as a recoupment, no amendments to sections 8(4)(a) or (m) are contained in the draft Bills thus leaving an exposure to double taxation.

Equally, amendments will be required to each of section 20 and paragraphs 3, 4 and 20 of the Eighth Schedule.

In addition we would question the validity of the proposed move to bringing into account for both income tax and donations tax the face value of the liability waived. Whilst the point raised in the EM as to the tautological nature in respect of insolvent companies is acknowledged, where term debt is waived we would suggest that a more equitable basis would be to bring into account amounts based on a discounted cash flow basis of the future flows.

Submissions

- **The necessary amendments to section 8(4)(a) and (m), section 20, and paragraphs 3, 4, and 20 of the Eighth Schedule be made so as to avoid the occurrence of double tax.**
- **The value of the debt waived to be brought into account should not be its face value but rather its net present value as determined using an appropriate discounted cash flow rate (ignoring any impact of insolvency).**

Anti-avoidance: Suspension of intra-group rollovers (EM 3.22)
Tax Bill Clause 75(1)(b)
Tax Act section 45

We refer initially to our comments in our covering letter as to (i) the dangers for South Africa resulting from the manner in which this proposal was announced, (ii) the need for section 45 to be retained for South Africa to have any semblance of an internationally competitive tax regime and (iii) the issue of labelling.

In short the removal of section 45 is a huge step back for the South African tax system. And when combined with the proposed changes to section 8E and the introduction of section 8EA could well sound the death knell for many BEE transactions.

We would state also that, despite Treasury's comments to the SCoF on the 15th of June the reality is that although they might hope to reverse the proposal and leave section 45 on the statute book until such time as they do so no-one will make use of the relief on the basis that the provisions in the draft Bill will not be enacted. Typically section 45 transactions are utilized to transfer assets of substantial value and the lack of certainty that the announcement of 2 June has brought about has been sufficient to place an absolute freeze on many transactions. In this regard a large amount of corporate activity has simply halted.

It is also worth pointing out that in this regard that many of the transactions not yet implemented have been held up pending approval from other regulatory authorities, be it the DMR, the JSE, Competitions Commission, SRP, SARB or others. Companies which have spent millions of Rands in bringing their transactions to, almost conclusion, with approval of the Regulatory bodies concerned are now frustrated at the final hurdle.

Turning first however to issue of international competitiveness, it was with great interest that we read Professor Keith Engel & Franz Tomasek's article, in the Business Report of June 15, 2011, on the perceived abuse of section 45 for acquisitions of shares or leveraged buy out transactions. In the article vague comments that interest expenses incurred to fund the acquisition of shares should not deductible, but are now being claimed as an expense through the abuse of section 45 are made without properly analyzing the basis for such a proposition. If this proposition is correct one can understand their discomfort.

It is however this proposition that we believe needs to be reconsidered. South African tax law is replete with decisions by the highest courts on the deductibility of interest arising from loans used to fund the acquisition of shares. The argument that has always been put forward by the authorities is that one should not be able to deduct the interest cost on a loan where the loan is used to fund the acquisition of shares on the basis that the shares produce exempt income. On the face of it, it may appear to be a very reasonable argument given the law as it currently stands and the lack of corporate groups when our courts considered the matter for the first time many decades ago. In truth it is however, nothing other than a fallacy and not based on principle. This can very easily be shown up by a very simple example of 2 very different but very similar transactions.

Transaction 1: Holdco acquires plant and machinery from its competitor that it uses to produce income. Holdco funds the acquisition with loans from the bank on which it pays interest.

Transaction 2: Holdco acquires the share capital in a company (that owns the plant and machinery) ("the target") from a competitor and target continues to use it to produce income. Holdco funds the acquisition with loans from the bank on which it pays interest.

Economically and on a principled basis there is no difference between the 2 transactions. However, the authorities would argue that they are very different and that any attempt to structure Transaction 2 in way that makes the interest expense deductible under Transaction 2 is an abuse of section 45. This is plainly not the case as it is clear on a principled basis that the interest under Transaction 2 should be as deductible for tax purposes as the interest expense under Transaction 1 is, as it is being incurred to generate taxable income for the group in the target. It is this assertion, which gets the authorities into a tizz.

In both the above examples the Funder's position is the same, it generates taxable interest. Permitting a deduction to Holdco in either scenario thus achieves neutrality, a deduction matched by income. Denying Holdco the deduction in scenario 2 results in a net plus, ie a detraction from taxpayer neutrality and consequently an inequitable position in the tax system with the resultant dangers that brings.

It is very firmly our view that this issue will only come to rest once the authorities accept the theoretically correct position and adopts a principled approach in line with most modern tax systems (such as the USA, UK, Australia and most of the European continent) in relation to the deductibility of the interest expense in Transaction 2.

As was acknowledged by Treasury before the PCoF (as the committee then was when this aspect was discussed previously) the usage of section 45 in leveraged buyout transactions arises as a result of the absence of interest deductibility on shares and group taxation. Once the system incorporates these core fundamentals found elsewhere it can be seen that the use of section 45 to achieve the same result should not give rise to concern. In such instances the acquiring company will get the deduction with the lender being subject to tax on the interest thereon (or in the case of a foreign lender subject to the withholding tax on interest).

With regard to BEE transactions however it is critical that a few key commercial aspects are first covered.

Firstly, government is promoting a more inclusive, broad based, approach than the first round of empowerment which unfortunately benefited only the few.

To achieve this aim, given that the broad based community do not have the funds to acquire the equity themselves, the reality is that either (i) the community ('**BEE Party**') or an acquisition vehicle must be funded to acquire the shares in question ('**BEE SPV transactions**') or (ii) a new vehicle must be established and leveraged to an extent that enables the broad based communities to afford the, reduced, entry price ('**leveraged BEE transactions**').

Prior to the global financial crisis, the majority of BEE transactions were funded using the BEE SPV model (ie debt was incurred by the BEE parties). This model has been the subject of a lot of criticism due to its lack of sustainability. Indeed history has now proven that this model is inherently risky and sub-optimal for sustainable empowerment due to, inter alia, the volatility in share prices not matching the fixed profile of the related funding obligation of the BEE parties. Furthermore, as funders are effectively taking equity exposure to the underlying shares, the funding rates on such transactions are high, leaving little if no benefit to the BEE parties. To enhance the sustainability if such transaction credit support needs to be

given by the empowering group. Section 8EA will however now make this uneconomical (see further comments below). It is also important to note that the direct funding of the BEE party results, rightly so, in a reduction in the points available for BEE scorecard purposes.

It is also important to note that funding of the community results in a reduction in the points available for BEE Scorecard purposes and so is not considered to be the optimal solution. In addition, previous analysis and market experience has shown that the above model does not result in real empowerment being retained at the end of the funding period, with (on a funding rate of 15%) growth rates of almost 2 000% required to retain the stake originally required. Even though the BEE SPV transaction model has its downsides it is often the only option to conclude a BEE transaction where, for example, the assets of the company cannot be moved, either for commercial reasons such as licenses that may not be moved or due to punitive tax costs where section 45 does not apply.

From a tax perspective, the law as it currently stands does not permit a tax deduction for interest incurred to finance the shares. For this reason many BEE SPV transactions done on this basis have been funded by way of preference shares issued by the BEE acquisition vehicle, with the funding terms typically on a 5 to 7 year term. However the proposed changes as regards s8E and 8EA are aimed at converting the dividend return to the funders on such shares to being taxable interest with the result that, whilst still not deductible for the borrower, the funder will charge the more expensive debt rates (as opposed to cheaper preference share rates) to meet their overall return requirements. Even more concerning is that the dividends received on the ordinary shares held by the BEE parties may now also be subject to tax leading to what is effectively triple taxation as (i) the company paying the dividend does not get a deduction on the dividends paid but has been taxed on the profits earned, (ii) the BEE party is subject to tax on dividends received on the ordinary shares subject to security arrangements for the funding raised and (iii) the funder (ie subscriber for the preference shares) are also subject to tax on the dividends received.

The Leveraged BEE transaction model on the other hand, whereby the funding (be it by way of loan or preference share funding) is at the level of the operating business and not at the BEE level, is the only sustainable BEE funding model to implement and retain empowerment and has been proven as transactions concluded on that basis did not face the same pressure and in general are not "under water" compared to the BEE SPV transaction model.

In this model a Newco is created which buys the assets using debt from shareholders, external funders or a combination thereof. Since the BEE parties did not raise funding from their balance sheet this model represents the only model where the transaction is not share price dependant and the BEE party is not at risk since it did not raise the funding. It is the company who concludes the BEE transaction and/or external funders who are at risk for the repayment of funding.

The BEE Codes support this funding model and gives full funding or net equity value points for such transactions from day 1 of the BEE transaction (unlike the BEE SPV transaction model which will likely score 0 net equity value points).

Furthermore since funders have direct recourse to assets funding rates are reduced to significantly enhance the sustainability of these transactions. Since shares are issued at a nominal value it also supports broad based BEE. However, to achieve this result it is crucial for the operating business to be capable of being transferred to a new vehicle on a leveraged basis in a tax neutral manner. To date only section 45 has been the only viable alternative available to achieve this as the other reorganization rules require the transfer to be done in return for equity shares which result in the transferred business still having a high equity cost and barrier to entry for those without funds. In addition, it is very often required

to move assets into separate companies as separate assets require separate BEE parties for eg in mining where the empowerment of communities around a specific mine is required by the DMR and the only way to achieve this as part of a BEE transaction is to use Section 45.

In respect of the Leveraged BEE transaction model, if the transaction is funded with debt, whilst the company obtains a deduction for the debt incurred, the funder, albeit it the holding company or external South African funder are taxed on the interest received. If external funding is received one must then also assume that the taxpayer would put that money to work again which should also result in tax earned by the fiscus. If the transaction is funded with preference shares, the company is still taxed on its profits earned whilst the dividend is not taxable in the hands of the BEE recipient but also not deductable by the company paying such dividend. It is clear that the fiscus does not lose any revenue in such transaction. Furthermore, the BEE parties will now also realise value which will eventually be taxable relating to a net gain for the fiscus which it would otherwise not have received.

Should the funders engage in non legitimate transactions to convert the interest received to non taxable income such activities should be the target of legislation introduced or attacked under the anti-avoidance provisions as the BEE transactions concluded by corporate constitute legitimate commercial transactions

Taking the alternatives listed above in turn (by way of summary only) any borrowings to acquire shares is dangerous from a commercial perspective as the ability to repay is dependent upon the dividend yield on the acquired shares and also the share price volatility.

The removal of section 45 is thus seen as prejudicial in the extreme to BEE transactions and cannot be supported.

In respect of acquisitions, whilst section 45 is not available, companies will not be able to fund transactions with debt where the seller demanded the sale of shares as opposed to assets. Buyers very often are only prepared to by the assets of a company to deal with unknown liabilities and to reduce the cost of funding as this is a requirement by funders to only fund against known assets and liabilities. This discrepancy between buyers needing to buy the assets and sellers only being prepared to sell the shares has been acknowledged by SARS in various Rulings. If section 45 is not available such transactions will not be able to be concluded leading to loss of growth and jobs to the economy.

Furthermore it is a well known concept that acquisitions very often need to be funded with debt which is cheaper than equity funding. Introducing debt into the capital structure of a company of the funding of a transaction reduces the cost of funding which result in projects and assets becoming economical and thus, if concluded lead to new opportunities, economic growth and job creation. The removal of Section 45 and thus the inability to fund a portion of the transaction with debt will result in a loss of these opportunities to South Africa. In this context it should be noted again that in by far the majority of cases the company will obtain a interest deduction whilst the funder is being taxed on the interest, thereby no leakage to the fiscus. Furthermore the economic growth, creation of new opportunities and jobs will lead to a growth in South Africa's tax base and thus collections. We are strongly of the view that the abolishment of Section 45 will have significant and unquantifiable losses to South Africa.

It is appreciated that Treasury has expressed concern with regard to certain transactions that it has seen and that action must be taken in respect thereof. The solution however cannot be to turn off the relief to all transactions, the amending legislation must cut out and cauterize only the infection and not the entire limb.

Submissions

- **Section 45 should be reinstated immediately with Treasury circulating a new Media Statement to this effect.**

- **Targeted measures, based on the mischief that Treasury has seen and has alluded to should be introduced.**

- **Treasury made the point before the SCoF as to their lack of, or late access to, information as to how deals are structured. It is proposed that they should be party to corporate transactions placed before any other regulatory body (eg SARB, JSE, Competition Commission) as to how transactions are structured in advance of their being concluded (with necessary protections for market sensitive information).**

- **Relief for interest incurred on the acquisition of shares should be introduced, together with a form of group taxation (it is suggested that the surrender of losses would be the simplest to implement in the short term). It is acknowledged that this last proposal falls outside the scope of the Budget proposals (as did the revocation of section 45) but it remains a matter requiring urgent attention in light of the perceived problems its absence brings about.**

Anti-avoidance: Dividend cessions (EM 3.23)
Tax Bill clause 30(1)(n)
Tax Act – section 10(1)(k)(i)

Whilst we acknowledge the concerns described in the EM with regard to dividend cession schemes we are concerned that the proposed denial of exemption goes far beyond catching only the mischief targeted. In particular we refer you to our comments in respect of the matter related to EM 2.7 (page 2 et seq above) *vis a vis* the proposed change to the definition of 'dividend' and the denial of the exemption to any dividend received from a trust (even where the trust has a real exposure to the underlying share).

Submissions

- **As noted in respect of EM 2.7 above, the amendments to the definition of 'dividend' should be restricted to address the actual mischief and be so wide as to bring in a whole-sale new level of double taxation.**

Anti-avoidance: Debt without set maturity dates (EM 3.24)
Tax Bill clause 23
Tax Act proposed section 8G

Concern exists that the proposed changes, understood to be targeted at parties applying an interpretation that section 24J cannot apply, may inadvertently catch the property industry and variable loan stock companies in its net.

Those companies typically issue 'debentures' as linked units to their shares, with the debentures having no fixed maturity date. Under current legislation the income received by the company is then sheltered for tax purposes by the 'interest' on the debentures with the holder then subject to tax thereon.

Under the proposed scheme the company will no longer obtain a tax deduction on the interest, it being reclassified as dividends and so its underlying income will be subject to tax in the hands of the company with the dividend then being potentially subject also to dividends withholding tax.

It is not clear whether the targeting of perceived abuses was intended to catch these type of arrangements in its net.

In order to avoid any potential argument that the proposed provision can be side-stepped simply by having an instrument which stipulates payment on date of, for example, insolvency or liquidation still containing a date and as such falling outside the proposed provision the reference in the definition of 'perpetual instrument' should make it clear that the date must be a fixed date and not a date contingent on some event.

Submissions

- **Clarity should be provided as to whether any exemptions are contemplated for venture loan stock companies where the income is effectively passed onto the holders who are then taxed thereon**
- **The reference to "any date" in the definition of "perpetual instrument" should be replaced with the term "a fixed date"**
- **A definition of "fixed date" should be inserted which would exclude any date which is defined by reference to a contingent event.**

Anti-avoidance: Third Party Backed Shares (EM 3.25)
Tax Bill clauses 20, 21 and 22
Tax Act section 8E, proposed 8EA and section 8F

A number of fundamental principles arise from the proposed changes (and the reasoning set out therefore in the EM).

Firstly however we would highlight that, akin to the manner in which section 45 was summarily suspended, the extent of the amendments to sections 8E and 8EA was in no way foreshadowed by the limited description in the Budget. Whilst the Budget referred to the closure of 'dividend schemes' (certainly understood as the Budget indicated that these involved some mischief) there was no hint that the scope of the amendment would be so broad as to potentially taint all SPV funded BEE schemes or indeed any dividends on a private or public company (whether implemented or still to be implemented) with more than one shareholder. We do not consider it an exaggeration to say that the breadth of these proposals may be as damaging as the proposed change to section 45.

The usage of preference shares as a funding mechanism is typically driven by commercial (and not tax) factors. Given the (current) tax free nature of the receipt in the hands of the funder, borrowers can access funding at a lower cost of funding by issuing preference shares rather than borrowing on interest bearing loan account. This is particularly the case where, as noted in the Media Statement discussion on debt vs share financing, the borrower has no need for the tax deduction associated with interest bearing debt (eg existing losses or start up). For example, from the debtors perspective it can either borrow at either 10% by way of loan (7.2% post tax, if the deduction can be obtained) or 8.5% by way of issuing preference shares. Where the debtor cannot claim the tax deduction under the loan it is a straight cost question of 10% (loan) vs 8.5% (preference share).

Preference shares also carry the commercial benefits of having certain debt qualities in that they do not pass control (voting rights) to the funder nor do they typically give away the equity upside.

Secondly we refer again to our opening comments as to the need for the legislation to, as far as possible, be equitable and fair. In the presentation made by Treasury to the SCoF reference was made to equity in the system, with either two zeros or a plus one and a minus one equating to a neutral position. What the existing section 8E and the proposed section 8E and 8EA do is retain dividend treatment (denial of deduction and application of secondary tax on companies or the dividends withholding tax) on the payor company but treat the receipt as taxable income in the hands of the recipient, ie a net plus remains. Section 8F similarly treats interest payments as non-deductible in the hands of the payor whilst retaining the nature as taxable interest in the hands of the recipient. These can both be contrasted to the far more equitable section 8G which is proposed in the Bill in respect of perpetual debt instruments where the 'interest' is reclassified as a dividend in the hands of both the payor and the recipient.

The proposed change to section 8E, changing the period from 3 years to 10 years means that companies will be unable to access this cheaper funding for periods where the term of the funding is less than 10 years. We frequently see companies with funding requirements for 5 or 7 year terms (particularly in the context of BEE transactions) and to deny them the cheaper commercial funding currently available under preference shares is simply not acceptable. Shorter terms are normally stipulated by the funders as funding at longer terms impacts negatively on their own reserving requirements, thereby increasing the cost of funding of BEE transactions.

Even in the context of preference shares of less than 3 years (ie to which the current provisions potentially already apply) it is not clear to our mind how the provision can be justified in its current inequitable form. If the dividend payments are to be recharacterised as interest then this should be done on a consistent basis on both sides (payor and payee) as should be the case in avoidance circumstances where SARS makes an adjustment.

In addition the proposed section 8EA is simply staggering in both its breadth and effect. We are particularly concerned as regards the position for BEE transactions where the BEE party is funded by preference shares with the funder having security from the empowered group and also in respect of employee share schemes where again security offered by the employer group will taint the funding. This is aggravated with the proposed revocation of section 45 as parties are now left with no alternative.

A further concern with regard to section 8EA is the lack of any time frame. For example it would appear that if a put option is negotiated in respect a share held, even if on a wholly independent basis and unrelated to the original acquisition even 10 years or more earlier, this somehow justifies the dividend being treated as taxable.

Whilst, prima facie, the proposed section 8EA(3) goes some way to addressing the concerns a number of residual issues remain;

- Firstly it must be appreciated that no application for clearance can be made until the legislation is finalized and then applications must be made by 1 April 2012. The question therefore arises as to the capacity of SARS to deal with the multitude of applications which will no doubt be forthcoming;

- No provision appears to have been made for the process to be subject to objection and appeal;

- Linked to the capacity question a further issue arises with regard to the time-scale within which SARS / the minister will respond. On the basis that the fiscus must surely anticipate that there will be instances where the approval will not be given (otherwise one would hope the draft legislation would not even have been proposed) any time delay could result in substantial costs. Given the way securities are typically drafter the funder will invariably have gross-up protection to protect it and this cost would then be borne by the borrower, ie in a typical BEE deal the cost for be for the empowerment parties.

- Also in the context of the application process and timing of approval it must be borne in mind that what is proposed is a potential fundamental change to the basis of existing transactions – the uncertainty that will arise from the delays in the process is thus destructive to one of the key tenets of a good tax system.

- The clearance process contemplates only shares issued on or before 31 May 2012 – if the Commissioner approves such a transaction as not being of concern there is surely no basis then for not permitting future transactions to be funded on a like basis

We would also highlight that as drafted any dividend declared by a private company which is less than wholly owned by a single shareholder would appear to fall into the ambit of the proposed section 8EA by virtue of the preemptive rights either contained within the memorandum of association by reason of the

Companies Act requirements or in separate shareholders agreements. The reason for this is that the other shareholders would have the (contingent) first right to acquire the shares from a selling party. The existence of pre-emptives is a common term in any shareholders agreement (and particularly so in BEE deals) though will now it appears result in making all dividends, even on ordinary equity shares, taxable.

Clearly this could never have been the intention but again we highlight it to illustrate the need for targeted legislation.

Submissions

- **Section 8EA in its current form should be excluded from the proposed legislation.**
- **Any new equivalent must be on a far more targeted and narrowed basis.**
- **Any recharacterisation of dividend to income, as a result of either section 8E or 8EA, should be done for both payor and payee (as per the proposed section 8G for perpetual debt instruments where interest is recharacterised as dividend for both parties) and the basis on which SARS is obliged to adjust in the context of avoidance arrangements (refer section 80B(2))**
- **Similarly, section 8F should be amended such that any recharacterisation of interest to dividend is done consistently for both payor and payee.**

Sundry technical anomalies

Long-term insurance: Taxation of proceeds (EM 2.5)
Tax Bills Clauses 7(1)(x), 30(1)(h) and 122
Tax Act section 1, 10 and paragraph 55 of the Eighth Schedule

The EM refers to the proposed amendments taking effect for amounts received or accrued in respect of years of assessment commencing on or after 1 January 2012. However the amendment to paragraph (m) of the definition of 'gross income', the inserted s10(1)(gG) and (gH) and paragraph 55 of the Eighth Schedule are stated in the draft Bill as applying from 1 January 2012.

Unification of the Source Rules (EM 4.2)
Tax Bill Clause 24
Tax Act proposed section 9

The opening wording to the proposed section 9(1)(b)(i) and (c) should clarify that the amount be incurred by a person that is a resident and is not attributable to a permanent establishment of that person outside the Republic

Clause 5(2) – Amendment of section 9 of the Transfer Duty Act

Whilst the additional relief measures proposed are welcomed we would question what the rationale is for delaying its implementation until 1 January 2012 and would suggest that this be brought in on promulgation.

Given the language of section 9 starts with "No duty shall be payable in respect of the acquisition of property …." it is not clear why clause 5(2) refers to the application to "property acquired or interest or restriction in any property renounced"?

Is it the intention that the opening wording to section 9 should also be amended to refer also to "No duty shall be payable in respect of the acquisition of property or interest or restriction in any property renounced…."?

Clause 7(1)(j) – Amendment of definition of 'equity share' in section 1

The amendment proposed, being the deletion of the term 'or similar interest' does not accord with the detail in the explanatory memorandum which states the definition will be changed to include 'similar equity interests'.

Which is the correct position?

Clause 12 – insertion of section 6 quin

It is submitted that the word "and" needs to be inserted at the end of the proposed clause 6quin(1)(a).

Other matters
Amendments either not directly related to comments in EM or applicable in multiple instances

Section 9E
Tax Bill: Clause 161

Whilst the Bill defers until 1 April 2013 the implementation of Section 9E (applying a new level of tax on the dividend income of passive holding companies) we mention below a number of issues with the pending section.

Firstly the rate at which the tax will apply has not yet been disclosed.

Secondly, unlike the new dividends withholding tax which provides for a transitional period during which STC credits can be utilized, no such relief measure exists in section 9E with the result that double taxation can arise.

By way of example, assume the following two positions;

Scenario 1: Mr A holds 100% of Co X. Co X is a passive holding company. Co X has passive income and historical STC credits. When CoX declares a dividend to Mr A no further tax is due, either by Co X or Mr A.

Scenario 2: Mr A holds 100% of Co X. Co X's sole asset is its 100% holding in Co Y. Co Y has passive income and historical STC credits. Should Co Y declare a dividend to Co X such dividend will be subject to tax in the hands of Co X (at the yet to be announced tax rate).

The fact that section 9E(4) precludes the dividends withholding tax from applying where the section 9E tax is paid is of no consolation where no dividends withholding tax would have applied in any event by virtue of the STC credit.

As a bare minimum credit should be given against the tax imposed by s9E where the dividend received has a STC credit attaching to it (as has been done for the dividends withholding tax).

A further exposure to double taxation arises in cases where multi-tiered holding structures exist. In such instance no exemption is provided for instances where dividends have been subject to tax under section 9E in one company and are then on-declared to another passive holding company.

We do however question whether section 9E can be justified at all.

Submissions

- **Section 9E should be deleted in its entirety and not enacted.**
- **Failing the above provision should be made for exemption where existing STC credits exists (as is the case for the dividends withholding tax) and for where a dividend received has been paid out of profits already subject to tax in terms of section 9E.**

Stamp Duty and Securities Transfer Tax ("STT")

Prior to its replacement with the Securities Transfer Tax ("STT") Stamp duty was levied in respect of certain transactions involving shares.

Originally stamp duty was levied on the issue of shares and, in limited anti-avoidance circumstances only, on the cancellation or redemption of shares.

Prior to its repeal stamp duty was abolished on the issue of shares. In removing stamp duties on the issue of shares, the 2005 Budget contained the following statement

> "The resulting tax nonneutrality between debt and equity capital makes little economic sense because equity financing offers companies better flexibility in terms of payments over the long-term than debt financing"

We submit that the logic and policy underlying that decision should apply equally in the case of the redemption of shares. No duty is payable on the repayment of a debt and we would submit that the redemption of share capital should similarly be exempt from duty (now STT).

Securities transfer tax however is now levied on all cancellations and redemptions of shares (other than in a liquidation).

In the event that such charge is retained we would submit that a further exemption be introduced in respect of the redemption of shares on which duty was paid in respect of the issue thereof so as to avoid a double tax charge in respect of the same shares.

The reason provided to date for the lack of an exemption (or reduction) on cancellation or redemption is that SARS cannot track the original payment of stamp duty on the original issue. It is submitted that this is no reason to not provide the relief although relief could then be restricted to instances where the taxpayer can provide satisfactory evidence as to the payment of stamp duty on issue.

Submission

- **Exemption should be provided from STT on the cancellation or redemption of a share where a taxpayer can evidence that stamp duty was paid on the original issue of that share.**
- **In the absence of an outright exemption (where for example the fisc is concerned it may lose out on any increase in the value of a share) consideration should be given to a reduction for stamp duty paid on original issue.**

Interaction of STT exemptions in s8(1)(a) of the STT Act with the reorganization rules in the Income Tax Act

Each of the exemptions in section 8(1)(a)(i) to (v) contemplate a transaction "referred to" in the relevant section of the Income Tax Act, with such cross reference however being to the "section" as a whole and not only the relevant subsection containing the definition of the relevant transaction.

Each of those sections in the Income Tax Act in turn contain the following;

(i) a definition of the relevant type of transaction – in all instances in subsection (1) of the relevant section;

(ii) in each of s42(8A), 44(13) and (14), 45(6), 46(7) and (8), and 47(6), exclusionary circumstances (other than failure to meet the requirements of the definition in subsection (1)) which then disapply the entire section from applying – not just the relieving subsections but also subsection (1) containing the relevant definition; and

(iii) Within these exclusionary circumstances, in each of s42(8A)(a), 45(6)(g), 46(8) and 47(6)(b) are the exclusionary circumstances related to an election by a party to disapply the relief. In the case of s44 (despite what is said in the EM to TLAA 7 of 2010) such election is still contained in the definition in subsection (1).

Subsection (8)(a)(vi)(A), prior to its deletion by section 127 of the TLAA 7 of 2010, dealt with instances where no election was made to apply the relevant section of the Income Tax Act (where those sections previously required an election by the parties for the reliefs to apply). With changes to the legislation making application of the relieving sections for income tax purposes in respect of the relevant transactions automatic, subject to an election to disapply the reliefs, it appears that the thinking was that this subsection was no longer required.

However, if an election is made under any of s42(8A)(a), 45(6)(g), 46(8) and 47(6)(b) to disapply the relevant section of the income tax act, as stated above, this would apply also to the definition. It is noted that this interpretation would give rise to a somewhat circular argument, by disapplying the whole section it would also disapply the ability to make such an election which clearly can neither have been the intention or a conclusion which a court would readily support.

The concern is that such election out, by disapplying the relevant definition in subsection (1), when read with the cross reference language used in s8(1)(a)(i) to (v) of the STT Act (which could be said to incorporate the exclusionary circumstances in the relevant section of the Income Tax Act) would then appear to deny the STT relief.

Leaving aside the current anomaly of s44 (again, until the current bill the election was still in the definition in subsection (1) despite what was said in the EM to TLAA 7 of 2010), that self same commentary in respect of the deletion of s8(1)(vi)(A) would indicate that this is neither the intent nor interpretation of the authorities.

The position has however been further muddied by the recent issue by SARS of Private Binding Ruling No 101 (4 May 2011). That ruling states that the STT exemption in section 8(1)(a)(iv) (linked to section 42 relief under the income tax act) will apply notwithstanding that the transferor is not a South African resident. Whilst not explicitly stated in the ruling, the relevance of the transferor being a non-resident

would appear to be that section 42 will not apply by reason of section 42(8A)(b) in that the disposal by the transferor would not be taken into account in determining the taxable income or assessed loss of the transferor. As stated the ruling neither explicitly states that this is the point on which the ruling was sought (due to the confusion thereover) nor does it state explicitly on what basis the STT relief applies where section 42 cannot apply by reason of section 42(8A)(b).

The concern accordingly remains therefore that, notwithstanding the interpretation implied by the EM, whereby in instances where the income tax relief contemplated in any of sections 42 to 47 does not apply (whether by reason of an election being made to disapply the entire relevant section in the Income Tax Act (including the definition in the relevant subsection (1) or due to another subsection in the relevant section, such as section 42(8A)(b) potentially covered in the SARS ruling referred to above) that the STT relief would still apply, that in terms of the law as it reads this is not the case.

It is submitted that greater clarity could be achieved by amending the language in each of the subsections of section 8(1)(a) of the STT Act to refer to "as defined" rather than "as referred"

Submissions

- **The language in each of section 8(1)(a)(i) to (vi) should be changed from "referred to" to "as defined in section [42(1)] of the Income Tax Act", ie incorporating the specific subsection of the income tax provision in which the definition is contained.**

Interaction of Transfer Duty exemptions in s9(1)(l) of the Transfer Duty Act with the reorganization rules in the Income Tax Act

The issues identified in respect of the previous matter with regard to the interaction of the STT exemptions with the reorganisation reliefs apply equally in respect of the interaction between the transfer duty exemptions and the same income tax reliefs, although the language in the Transfer Duty Act is currently "contemplated in" as opposed to "referred to" used in the Stamp Duty Act.

Accordingly it is submitted the same amendments should be made to the transfer duty exemptions also.

Section 8C and related points

PAYE on vesting of restricted equity instruments – definition of 'remuneration' in paragraph 1 of the Fourth Schedule

It is noted that in terms of paragraph (e) of the definition of remuneration, gains determined under section 8C are effectively brought into account for purposes of determining the PAYE liability of an employee with the result that, in the month of vesting, PAYE will be accounted for and withheld by the employer in respect of any such gain.

By contrast, if a vesting results in a loss the employee must wait until submission and assessment in order to obtain the tax relief in respect of such loss.

We would submit that this situation is patently unfar and that parity should be applied for both positions.

Submissions

- **Section 8E should be deleted in its entirety and not enacted.**
- **Failing the above provision should be made for exemption where existing STC credits exists (as is the case for the dividends withholding tax) and for where a dividend received has been paid out of profits already subject to tax in terms of section 9E.**

Double taxation not addressed

The Budget Reviews of both 2010 (Annexure C at page 194) and 2011 (Annexure C at page 189) acknowledge concerns received that shares held in an employer trust could suffer double taxation. We again however do not see anything in either the explanatory memorandum or the draft bill to address this.

In its most basic form the issues arise where shares are held by an employee trust with the employee's direct interest being a participation unit in the trust (a relatively vanilla and not uncommon structure).

Both the equity share held by an employee trust and the employee's participation unit in that trust are "equity instruments" as defined by section 8C. Accordingly the potential for double taxation exists as a charge will arise in respect of both, once as regards the share at the outset (typically there are no restrictions on the share itself, however if granted at a discount, the discount will be taxable upfront as it will vest immediately) and then again, including the same discount, as regards the participation unit in the trust (once the restrictions thereon fall away).

This situation arises as a result of the fact that the employee and the trust will be 'connected persons' (the employee is a beneficiary of the trust). Accordingly, in terms of section 8C(5)(b), in addition to the equity instrument actually held by the employee (the participation unit in the trust), the share held by the trust is deemed to have been acquired by the employee and disposed of to the trust, with a subsequent vesting of the share then taxed in the employee's hands.

Again we state that it is wholly inappropriate to tax both and it is assumed that, bearing in mind the purpose of section 8C is to retain the income nature of gains, that the preference would be to rather tax the eventual vesting of the participation unit than the initial vesting of the share upfront. Provision therefore needs to be made to ensure that only one of the linked instruments is subject to tax.

Submission

Section 8C(5)(b) be amended to provide that where linked equity instruments exist, section 8C(5)(b) will not apply where the taxpayer who would otherwise have been deemed too have disposed of the equity instrument holds the linked instrument.

A further issue arises in respect of instances where the taxpayer is obliged, during the period when the shares are restricted to sell these back to his employer (or associated institution) as envisaged in s8C(5)(c). Section 8C(5)(c), when read with (2)(a)(i)(aa) and (b)(i)(aa) limits the gain or loss in such instances to being calculated by reference to the actual proceeds received.

Section 8C(5)(a) caters for instances where a taxpayer, having acquired a restricted equity instrument disposes of that instrument to a second person either not at arm's length or where such second person is a connected person. Section 8C(5)(b) in turn deems equity instruments acquired by a second person to have first been acquired by the taxpayer and then disposed of to that second person in the manner contemplated in (5)(a). These sections are thus of direct application to the example where shares are issued to a trust (the second person) by virtue of a taxpayer's employment.

By virtue of then applying subsections (2), (3) and (4) on a *mutatis mutandis* basis, section 8C(5)(a) provides that on a subsequent vesting of the instrument in the hands of the second person, any gain or loss is deemed to be that of the taxpayer who originally acquired the restricted instrument.

However, as the mutatis mutandis basis referred to in section 8C(5)(a) does not include section 8C(5)(c), it is not immediately clear that in instances where subsection (c) of section 8C(5) would have applied to the determination of the gain in the hands of the original taxpayer that this will in fact continue to be the case in the hands of the second taxpayer, the results of which are then included in the first taxpayer's tax calculation.

Although arguably this is achieved indirectly by section 8C(5)(a) applying subsection (2) on a mutatis mutandis basis, with subsections (2)(a)(i)(aa) and (b)(i)(aa) each then referring to subsection (5)(c), in order to provide clarity in this regard, we would suggest that the wording in section 8C(5)(a) be extended to apply not only subsections (2), (3) and (4) on a mutatis mutandis basis, but also (5)(c).

Submission

The closing wording of section 8C(5)(5)(a) be amended to read "the provisions of subsections (2), (3), ~~and (4)~~ <u>and (5)(c)</u> apply *mutatis mutandis* ......"

It is unfortunate that the perceived abuses are tackled (with which we agree) whilst drafting issues which are prejudicial to the taxpayer it appears have been left unresolved.

Additional issue

It is apparent from section 10(1)(k)(i)(dd) that dividends in respect of restricted equity shares are intended to be exempt where either (A) the share on which the dividend is declared is an equity share or where (B) the dividend constitutes an equity share.

However the latter does not align with the other sections in the Act as regards the issue of bonus shares by way of distributions in specie in respect of a restricted equity instrument.

Firstly the definition of 'dividend' in section 1 provides that an amount transferred by a company will not be a dividend to the extent that it constitutes shares in the company, accordingly the relief in section 10(1)(k)(i)(dd)(B) can never apply – surely this can never have been the intention.

Secondly section 8C(1)(a)(ii) provides that if further shares are acquired by virtue of a restricted equity instrument (as would be the case contemplated here) the value of those shares (on the basis the bonus share is unrestricted) would vest immediately and be included in the taxpayer's income in terms of section 8C(2)(a). Again the impact here is to negate the exemption afforded by s10(1)(k)(i)(dd)(B).

Submission

The interaction between section 10(1)(k)(i)(dd)(B) and each of the 'dividend' definition in section 1 and section 8C(1)(a)(ii) should be clarified, with certainty provided that distributions in specie will be exempt.

Offset of foreign trading losses
Proviso (b) to section 20, read with section 20(2A)

Proviso (b) to section 20 limits the ability to offset foreign trading losses against South African trading profits. Whilst we question the continued validity of such measures given that South Africa levies tax on a worldwide basis (see further below) an anomaly arises in the context of taxpayers who are not companies.

In terms of section 20(2A), for trusts and individuals (non companies), in determining the income against which the foreign losses may not be offset against, both trading and non-trading income is included (irrespective of source). The result of this is that foreign trading losses may not even be set off against foreign investment income. We would suggest that this cannot have been the intention.

Submission

Limit the application of section 20(2A) to "taxable income derived by the taxpayer from a South African source otherwise than from carrying on a trade".

We would highlight however that this is not the end of the matter. Even if the above is adopted it does not enable foreign trading losses to be offset against foreign capital gains, a situation which again we consider cannot be justified from a policy perspective.

Whilst resolution of, at the least, the above anomaly detailed above for which a solution is given, we would suggest that broader consideration needs to be given as to whether the continued limitation imposed can indeed remain justified where South Africa imposes tax on a worldwide basis.

Turning back to whether any limitation can be justified, the explanatory memorandum accompanying the amendment Act in 2000 which introduced worldwide taxation contained the following statement;

> "It is proposed that the foreign losses incurred by an individual or a company should not be set off against the South African income of the individual or company. This is proposed in order to protect the existing tax base as there is no information available relating to the magnitude of foreign losses and to what extent this may erode the current South African tax base. Such a measure will also limit the possibility of a person starting a foreign operation in a branch in order to utilize the losses against the South African income and then converting the branch to a separate subsidiary company when it becomes profitable. This could have the effect that the income would be exempt once the branch showed a profit whilst the losses previously allowed would not be recouped."

Over 10 years have now passed since this statement was made, with residents being required in that period to report their worldwide income (including foreign losses). Accordingly the position that "there is no information available" is not longer a valid stance. SARS' records must now surely contain this information. In addition the blanket denial of offset on the basis of the example given (branch being converted to a subsidiary when moves from losses to profits) is not justifiable. Other jurisdictions deal with this by way of a recoupment to prevent erosion of the tax base and not an outright denial and it is submitted that this could be effected in South Africa also.

Submissions

- **Reconsider whether, given that South Africa levies tax on a worldwide basis, any restriction on the offset of foreign assessed losses is appropriate.**
- **As regards the avoidance concern referred to in the 2000 Explanatory Memorandum, provide for a recoupment to address the concern.**