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Dear Sir

MOTIVATION FOR GROUP TAXATION IN SOUTH AFRICA

We set out below the SAICA's National Tax Committee submission comments in relation to the motivation for group taxation in South Africa.

This document sets out motivation for the introduction of 'group tax' in South Africa, for consideration by National Treasury and the South African Revenue Service ("SARS"). The motivation proposes that the phasing in of group taxation be continued with the immediate introduction of loss sharing provisions, moving eventually to a South African version of group relief/fiscal unity (see discussion) as seen in the UK and Holland.

The proposal considers the continuation of the phasing in of the recognition of the fiscal unity of group of companies ("group taxation") on the following basis:

- The current elements of 'group taxation' set out in the Income Tax Act No. 58 of 1962 ("the Act"), principally those that permit the tax-free transfer of assets between group members, be retained, on the basis that they continue to be refined;
- Provision be made for loss sharing between 'group' members to a tax neutral position, ie losses transferred may not create a loss in the transferee company;
- The definition of 'group of companies' be retained ie to include companies held at or above a 70% level, but excluding specified types of companies (specifically non residents for the present). This level of shareholding is designed to ensure that BBBEE initiatives are not affected. However, if considered to create too much risk for SARS, a 100% shareholding requirement could be initially considered;
- Election to be made on a 'one in, all in' basis (ie all members of the group must participate, so that all group members with losses *must* transfer those losses to group companies with taxable income), for a minimum period of three years, with three year roll over periods;
- Tax returns of all companies in the group to be submitted to one office;

- Intra group charges to be as per financial statements of individual companies. Transfer of losses should mitigate local transfer pricing using inter-group charges. However, the purpose for which funds are borrowed is looked at on a group basis ie interest will be deductible provided used in the group to fund operations regardless of how the funds reach their destination;
- Ring fence losses on joining group;
- Attribute CFC income to one company in the group; and
- Special rules for special types of companies eg farming; mining to retain ring fencing required in those companies;

Discussion

Group tax has been implemented in various forms throughout the world[1]:

The Organshaft Regime: This treats the subsidiaries as organs of the holding company, and together they are treated as one body. The profits and losses of the subsidiaries are attributed to the holding company. This regime does not cater for the deferral of gains and losses arising from the intra group transfer of assets. The regime has been adopted in Germany and Austria.

Group Contribution: Under this regime the profit making companies in the group make a contribution to the loss making companies, and can deduct that contribution. This is an effective transfer of wealth from one company to another. The regime has been adopted in Sweden, Norway and Finland.

Group Relief / Fiscal Unity: Here losses are transferred from one company to another to the point that there is a neutral position (ie losses are not created in the transferee company). Each company submits its own tax return. The regime has been adopted in the UK, New Zealand and Singapore. (Fiscal Unity in the Netherlands).

Consolidation Regime: This is the most implemented regime, although it is applied in different forms in different countries. It involves corporate income being computed at the corporate level, but being combined at group level for tax purposes. The parent therefore pays the tax for the whole group. Intra group transactions are ignored. The regime has been adopted in Australia, Denmark, France, Italy, Japan and the USA.

Both the Margo Commission Report (1987) and the Katz Commission Report (1995) looked at the viability of group taxation in South Africa. The Margo Commission was in favour of the concept, but did not believe South Africa was ready. The Katz Commission, on the other hand, recommended a gradual introduction of group taxation. Both Reports indicated a leaning toward the group relief regime, but due to complexities particularly relating to the election process, settled on favouring the consolidation method.

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[1] *Detail of Group Tax Regimes taken from Cahiers De Droit Fiscal International (2004) - International Fiscal Association, 2004 Vienna Congress-Studies in International Fiscal Law, Vol 89b.*

However, the recommendation of a gradual move to group tax was not implemented due to other priorities at the time, and concerns regarding some of the aspects of group tax, specifically loss to the fiscus, inadequate resources at SARS and tax avoidance. What has, however, evolved, is legislation that contains various elements of 'group tax', but not a fully operationally recognised group tax system:

Inter alia the following sections in the Act already contain elements of group tax:

- Sections 41 - 47;
- Connected persons definition in section 1;
- Section 9D –CFC legislation;
- Section 24I(10);
- Donations tax exemptions – section 56;
- Secondary tax on companies rules- sections 64B and 64C; and
- Eighth Schedule: Para 12(5).

The next step closer to a group tax regime is, therefore, a move to allow the transfer of losses within a group. This is also considered more appropriate in the South African context since the full consolidation system also requires complex tax accounting and is more suited to first world countries, especially where there are ownership interests less than 100%.

The reason why the time is ripe for this is that the reasons previously cited as to why further implementation should not take place have fallen away:

Loss to the fiscus:

- As indicated by the Margo Commission, clever tax planning often achieves the same result as transfer of losses, in any event;
- South Africa is at a competitive disadvantage when compared to countries with a group tax regime which allows transfer of losses between group companies when it comes to attracting investment. Additional investment into South Africa would result in a larger tax base;
- SARS is now much more sophisticated in its ability to address tax avoidance;

Inadequate resources at SARS:

SARS has reorganised itself in the last 10 years to be a much more efficient organisation, and with the advent of e-filing many more resources have become available. Thus, the concern that SARS has inadequate resources has somewhat fallen away. Furthermore, if all group tax regime taxpayers in a group must file in the same tax office eg the large business centres, these centres are already suitably resourced.

Tax avoidance:

The loss transfer rules would need to incorporate anti avoidance provisions. Suggested provisions would include the ring fencing of pre group losses; three year , 'one in, all in', rules (if the definition of a group is set at shareholdings of 100%); all group companies to be assessed at the same tax office; specific rules for special types of companies eg insurance, farming; attribute CFC income to one company in the group.

What is a group?

It is recommended that the definition of 'group of companies' as currently set out in the income tax legislation be retained ie to include companies held at or above a 70% level, but excluding specified types of companies (specifically non residents for the present). This level of shareholding is designed to ensure that BBBEE initiatives are not affected. However, if considered to create too much risk for SARS, a 100% shareholding requirement could be initially considered;

Advantages to Corporate Taxpayers

Tax policy should be designed to support economic growth rather than to simply raise revenues for the fiscus. Although this topic is being raised during times where the fiscus is estimating a significant shortfall and a budget deficit much greater than it has been for many years, it has to be borne in mind that when economic recession arises, groups are prejudiced when they pay tax in one company but have losses in others. The tax cash outflow can, unnecessarily, bring the group to its knees, essentially 'killing the goose that will lay the future golden egg' for the fiscus.

Below, some of the advantages and disadvantages of the group tax regimes are set out:

Advantages

1 Set off of profits and losses - The main advantage of a group tax regime is the ability to set-off profits against losses between group companies, yet preserve business and legal advantages of a separate company eg limited liability. Similarly, capital gains/losses may be able to be set-off across group companies.

2 Flexibility – allows businesses to organise themselves in the best way from a pure economic perspective without worrying whether the structure is the most efficient from a tax perspective.

3 Leveraged acquisitions – Potentially provides for off-set of acquisition interest expense against operational profits. Similarly, unproductive interest leakage could be mitigated where holdco borrows externally at a higher interest rate to lend to subco at a lower rate.

4 Trading concept – where a taxpayer needs to show company trading in order to preserve tax losses will take lesser importance.

5 Intra-group transactions carry minimal tax leakage eg deemed dividend issues, capital gains, transfer pricing arrangements are largely neutralised through redundancy and thus meticulous record keeping avoided etc.

6 Cross border loss off-set.
In many countries eg as in the UK, companies can claim foreign tax losses of its, say, 75% or more owned sub or a PE in the European Economic Area. Although we recommend that, initially, non SA losses be ring-fenced, SA could apply similar rules for losses in the CMA or SADC region in the future.

7 Foreign tax credits transfer.
Where a SA company receives income which has suffered tax in another jurisdiction, the company is allowed to claim relief from SA tax on the amount of tax suffered offshore, up to the equivalent amount of SA tax which would be paid on the same income. The excess foreign tax credit could potentially be surrendered to other SA Group companies.

8 Reduces the number of provisional tax payments and reduces cash outflow where there are loss making companies within the group.

Disadvantages

1 Administratively burdensome – Making election and effecting set-offs may be administratively burdensome to the group.

2 Subsidiaries with different financial year ends are required to change to the same year end as parent. This is however, rare.

Special taxpayers

A simplistic view to the application of a group tax regime in circumstances where the structure of the tax computation of certain trades deviates from the normal tax computation structure, is that if the remainder/taxable income calculated is subject to tax at the corporate tax rate, currently 28%, then that trade should be included in the group tax regime. Taking this argument a step further, then the most suitable group tax regime would be the "loss transfer" regime for the following reasons:

The taxable income or tax loss of each trade must be determined in accordance with the tax principles applicable to that trade;

The tax losses can then be transferred to the operations with taxable income;
The net tax liability is determined;

Specific tax treatments

It is submitted that the group tax regime proposed can apply equally to taxpayers who experience special tax treatment in terms of current tax legislation. This is illustrated below:

Long term insurers

Long-term insurers are taxed in terms of section 29A of the Act, based on the four-fund principle. The funds comprise the untaxed fund, individual policy holder fund, company policy holder fund and the corporate fund. The corporate fund comprises returns and assets which are not attributed to the other three funds.

The returns and assets attributable to the untaxed fund, individual policy holder fund and company policy holder fund are attributable to the policy holders whereas the shareholders of the long-term insurer can enjoy the benefits of the assets attributed to the corporate fund. As such the four funds do not comprise a group of companies for tax purposes.

With reference to the "loss transfer" regime, a long-term insurer which forms part of a group of companies would calculate its tax based on the principles provided for in section 29A of the Act. Any taxable income or tax loss attributable to the corporate fund can then be applied against the taxable income or tax losses of any of the other operations of that group of companies.

Farming operations

Group of companies with farming operations within the group should also be able to participate in a group tax regime. The taxable income or tax loss of the farming operations could be calculated before taking into account any paragraph 12 of the First Schedule to the Act adjustments. Paragraph 12 allows a deduction of certain farming development expenditure to the extent that there is taxable income from the farming operations. Any excess development expenditure is carried forward and may be deducted against future farming taxable income.

Currently companies which have farming operations as a division within its overall operations have to perform a separate tax computation in respect of its farming operations in order to determine the deduction of the farming development expenditure incurred.

It should also be possible to incorporate this methodology in a group tax regime. The aggregate of farming development expenditure may be deducted from the aggregate of the taxable income all the farming operations. The same limitations can also apply but at the aggregated farming operations level. Special provisions may be required to deal with situations where farming operations with unclaimed farming development expenditure are disposed of during a tax year.

Mining Operations

The specific tax treatment of mining operations, and in particular prospecting and capital development expenditure, is set out in sections 15 and 36 of the current tax legislation. The capital development costs, pertaining mining operations at specific mines are currently ring fenced. Thus, although the loss transfer regime may be appropriate for other aspects of mining companies specific rules would need to be put in place (eg the losses arising from prospecting costs would be confined to transfer to other mines of the same class).

Toll road operations

As is the case with farming operations, section 24G of the Act limits certain expenditure to the taxable income attributable to toll road operations. The same principles as proposed in respect of farming operations should also apply to toll road operations.

Oil and gas operations

Group of companies with oil and gas operations within the group should also be able to participate in a group tax regime.

Specific group tax provisions could be introduced to deal with the limitation of the set-off of losses in respect of exploration or certain production against sales from oil and gas and refining operations (paragraph 5(3) of the Tenth Schedule to the Act) as well as ability to set-off 10% of the losses against other income provided for in paragraph 5(4) of the Tenth Schedule to the Act.

Tax treatments where different tax rates apply

There are no compelling reasons why companies which are not subject to the standard corporate tax rate of 28% should be excluded from the group tax regime. In these situations the companies within a group of companies, which are taxed at the different rate, could participate in a group tax regime where those companies are taxed as part of a separate group from the group which is taxed at the standard corporate rate. An example of such companies is gold mining companies.

Detailed work would need to be performed to evaluate how to apply the loss transfer system to each of these types of taxpayers who are subject to specific tax regimes. However, the analysis above is designed merely to illustrate the possibilities. Specialists in each of the areas could form working groups to propose the finer details

Consideration of other taxes eg VAT

Consideration also needs to be given to eliminating the incidence of VAT between fully Vatable group members. This would significantly decrease the administration burden of raising VAT invoices for the supply of goods and services between group companies, and furthermore, reduce the burden for SARS in policing these transactions.

Conclusions

SAICA recommends that National Treasury and SARS considers the implementation of a group tax regime as set out above, for the reasons indicated.

We request a meeting to further engage on the proposal.

Please do not hesitate to contact us, should you have any questions regarding the above.

Yours faithfully

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