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Standing Committee on Finance
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Dear Sir

CALL FOR COMMENT: 2013 TAX RELATED BUDGET PROPOSALS

We would like to firstly thank you for the invitation to present both written and oral comments to the Standing Committee on Finance ("SCoF") on the fiscal framework and revenue proposals as was announced by the Minister of Finance on 27 February 2013.

The comments are made by members of our National Tax Committee and are aimed at the proposals that relate to amendments to the tax laws and therefore their impact on estimates of all revenue.

Administration
The Tax Administration Act allows for the appointment by the Minister of the Tax Ombud and requires that the appointment be made before 1 October 2013. SAICA received a number of reports from our members and taxpayers were they were unable to solve disputes between SARS and themselves. At the moment these issues are referred to the relevant persons, but we were hoping that the appointment of the Tax Ombud would have been made in the 2013 Budget.

We trust that the appointment will be made shortly.

Bursaries
SAICA made a submission to National Treasury during September 2012 **(attached)** and is therefore pleased that it received specific mention in the budget. From the speech it is clear that it addresses the monetary amounts. We trust that the remuneration problems raised in our submission will also receive attention when the monetary amounts are adjusted. We attach our submission to these comments for a more detailed explanation of the issues raised by us.

The timing of the budget and availability of employees' tax tables

Background

Long-term insurers pay annuities to pensioners or annuitants who have voluntarily purchased annuities. Annuities are subject to employees' tax and long-term insurers consequently rely on the tax tables and other tax rates (rebates etc.) announced in the National Budget each year to determine the tax to be applied in the new tax year.

Unlike wages or salaries payable to common law employees, annuities can be paid to annuitants on any day of the year, including 1 March.

The correct tax on annuities must be determined and deducted before they are paid. This includes the running of tax programs to aggregate the tax rates for taxpayers who receive more than one annuity from the same long-term insurer. As the calculation of tax is reliant on the tax tables, the timeous release of new tax tables is critical. Failure to accurately calculate the tax for annuitants will lead to them being inadvertently over-taxed in the first month, and they will only receive the relief of the amount overtaxed during the course of the tax year- this is unfair to this vulnerable group of taxpayers.

As aggregation programs may take two days to run and the release of payments to annuitants at least two days to release to the bank, Long-term insurers need to have sight of, and load the new tax tables, at least a week before the 1 March each year.

This year's budget took place on 27th February 2013, two days before the commencement of the new tax year. This consequently put extreme pressure on long-term insurers for the annuity runs commencing on 1 March 2013.

Long-term insurers request that the tax tables and other tax rates be released to them on a confidential basis at least two weeks prior to 1 March each year. This will eliminate the risk of not being able to load the new rates in time and will ensure that annuitants are correctly taxed from 1 March each year.

Registration as a vendor for purposes of Value-Added tax

SAICA considers the issues currently faced by persons when they apply to be registered as vendors for purposes of Value-Added Tax to be a serious hindrance to doing business in South Africa. Persons affected by this are those who are obliged to register, those who take over a going concern, foreign entities wishing to carry on business in the RSA and new enterprises where supplies will only be made after the first year.

We made a submission during 2011 relating to VAT registrations and the Minister mentioned the issue in the 2012 budget. National Treasury and SARS then met with the industry during June 2012 to obtain an understanding of the issues. No amendments were made to the law and in fact the requirements to register were since changed by SARS during the year.

With the Tax Administration Act being implemented last year the problems that vendors face when they are registered late have increases. It is particularly the penalties that are automatically levied for late submission of returns, late payment of the amounts due and then also the fact that person cannot comply with the documentary requirements relating to tax invoices.

The proposed amendments to the taxation of trusts

The Minister stated the following on page 54 in Chapter 4 and under the heading "Reforming the taxation of trusts":

> "Certain aspects of local and offshore trusts have long been a problem for global tax enforcement due to their flexibility and flow-through nature.
> To curtail tax avoidance associated with trusts, government is proposing several legislative measures during 2013/14.
> The proposals will not apply to trusts established to attend to the legitimate needs of minor children and people with disabilities".

Our comments

Contrary to SARS view, trusts are not created with the view to avoid tax – be it income tax, capital gains tax, estate duty etc. One of the main purposes of trusts is to protect assets from claims against an individual. In today's legislative framework, individuals who practice as qualified professionals (lawyers, accountants, medical professionals etc.) by nature of their chosen professional and limitations placed on their ability to operate in a corporate environment, find themselves open to potential liability claims which can have a significant impact on their personal financial situation. The same can be said for directors of companies in certain circumstances. The only means available to these individuals to secure their private and personally held assets from claims is by way of a trust. SARS seems to have lost sight of this aspect and need to address these issues before making the changes suggested.

It was only in 1991 (after the Friedman case) that the Income Tax Act was amended to specifically include a trust as a person for purposes of Income Tax. The amendment followed the decision in the high court and in the Court of Appeal where Judge Joubert said the following: "Is a trust a legal persona? According to the Anglo-American law of trusts a trust has no legal personality" and later "It is clear therefore that a trust is not an incorporated company. Nor is a trust a body of persons un-incorporate whose common funds are the collective property of all its members".

It is submitted that the reason why persons would vest income and capital gains from a trust is because of the high tax rate in the trust. If the trust was taxed at the same rate that would apply to the beneficiaries this would not have been a problem.

In an article in the January / February 2013 issue of Accountancy SA the author (Franscois van Gijsen) makes the following comment:

> "I am of the opinion that, if you consider the potential savings through the generations and also the protection that trust assets enjoy from creditors, a short term tax saving by allocating and vesting assets to individuals does not justify depriving the beneficiaries of the protection that the trust has to offer. Trustees and advisors should guard against losing sight of the objectives of the trust and take care not to deprive the authentic beneficiaries of this protection".

We believe that the following comments made by Judge Madjiedt in Raath v Nel (in the Supreme Court of Appeal during May 2012) are also relevant to the issue:

> "It is plain from the above that the trust is of the type which has become very popular for estate planning and tax purposes (as was the case in Rudman). It is undoubtedly a convenient and useful tax and estate planning vehicle, but the caution sounded by this court in the past is apposite here. In Nieuwoudt & another NNO v Vrystaat Mielies (Edms) Bpk, Harms JA raised a concern about business trusts where a trust is formed for estate planning purposes, or to escape the constraints of corporate law, and yet everything else remained as before. A similar concern was raised in Land and Agricultural Bank of South Africa v Parker & others. There, as is the case here, the dispute revolved around a family trust. This court reaffirmed that a trust estate, comprising of an accumulation of assets and liabilities, is a separate entity, albeit bereft of legal personality. It emphasized that the core concept of a trust is the separation of ownership or control from enjoyment, i.e. that even though 'a trustee can also be a beneficiary, the central notion is that the person entrusted with control exercises it on behalf of and in the interests of another'. And Cameron JA pointed out that:
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>> 'The courts will themselves in appropriate cases ensure that the trust form is not abused. The courts have the power and the duty to evolve the law of trusts by adapting the trust idea to the principles of our law… This power may have to be invoked to ensure that trusts function in accordance with principles of business efficacy, sound commercial accountability and the reasonable expectations of outsiders who deal with them.'

Where the decision to vest income (or gains) in a discretionary trust has the sole or main purpose to obtain a tax benefit it may constitute impermissible tax avoidance. The avoidance concern is, in our view, adequately addressed by the general anti-avoidance legislation already in the Tax Act. There is therefore no need to change the legislation based on the tax avoidance concerns only. The taxation of trusts, as is the law of trusts itself, is a complex issue and proper research should be carried out before the law is changed.

The Estate duty comment

The Minister's comment in this regard reads as follows:

> "Also of concern is the use of trusts to avoid estate duty, which will be reviewed".

There is no mistaking the fact that the death of an individual potentially involves both a tax on the deemed capital gain that arises on death and estate duty on the net value of property in that persons estate. The increase in the effective rate at which the capital gain is taxed (effective 1 March 2012) is only marginally off-set by the R300 000 exclusion.

It is again suggested that Estate Duty Act be amended to bring in a general tax avoidance principle and that the amendment of the taxation of trusts is not the appropriate way to achieve this.

The minister announced in a budget speech two years ago that the abolishment of Estate duty is being considered. Amendments to tax law that has as its purpose the reduction of Estate Duty may therefore have a limited benefit to revenue collection.

Offshore foundations

The Minister's comment in this regard reads as follows:

> "Distributions from offshore foundations will be treated as ordinary revenue. This amendment targets schemes designed to shield income from global taxation".

Our comments assume that a foreign foundation is similar to what we, in a South African legal sense, understand as a trust. This proposal by the Minister does not distinguish between distributions that are of a capital nature and other distributions, but it appears that the intention is to treat all distributions, irrespective of nature as income. There is no reason to change, and the intention to do so certainly does not appear from the budget proposals, the well-established conduit principle. The introduction of section 25B codified the conduit principle and the amendment was necessary after the amendment referred to above which followed the decision in the Friedman case. Our Income Tax Act was only recently amended to tax foreign dividends principally the same as dividends declared by RSA resident companies. The proposal to tax distributions "as ordinary revenue" would for instance treat foreign dividends no different to foreign rental income and would defeat the stated intention with regard to the taxation of foreign dividends.

If a foreign foundation is similar to a trust (in the RSA context) it should be treated as such in tax matters and the conduit principle should apply to distributions.

The proposals relating to cross-border services and pensions

We welcome the following statement: "Given the complexity of the issues involved, extensive consultation is required. Possible legislative action may occur if consensus is easily achieved (such as neutralising any unintended differences between cross-border lump sum payouts and annuities)". We will communicate our availability to be part of the consultative process to National Treasury.

The comments below are therefore general in nature.

Cross-border services

OECD best practice alludes to the source of employment income being where the services are rendered. The current regime allows for an exemption when an individual renders services outside the RSA. The exemption applies where the employee was outside the RSA for a period(s) exceeding 183 full days in aggregate during any period of 12 months; and for a continuous period exceeding 60 full days during that period of 12 months, and the services were rendered during that periods.

In most double taxation agreements the RSA has given the right to the foreign country t tax this income if the recipient (the employee) is present in the other State for a period or periods exceeding in the aggregate 183 days in the calendar year concerned. The exemption therefore addresses the double tax that would otherwise arise as South Africa taxes on a basis of resident status (world-wide basis).

In terms of the Budget Speech it was announced that the worldwide tax regime should be extended to cover South Africans on long term assignment offshore. We can only assume that this means that South African residents working abroad who currently qualify for the foreign earned employment income exemption will be subject to tax in RSA with the opportunity to claim a foreign tax credit on submission of the final return. Unlike other countries which have abolished the foreign earnings exemption, SA makes it very difficult to break residence on an outbound assignment. South African outbounds are likely to remain resident and be taxable on worldwide earnings. This is quite different to the UK, for example, where residence can be broken with one tax year worked abroad, and a foreign earnings exemption is not necessary.

Furthermore, where an SA resident outbound assignee does break residence (e.g. by operation of a DTA) they suffer an exit charge. Again, this is in contrast to other countries where breaking residency does not have such a significant penalty/downside. While several countries do have an exit charge, it is typically subject to an election whereby the taxpayer may remain in the home country CGT net post-residence (e.g. Australia and Germany). No such election is available in SA. Any reform of section 10(1)(o)(ii) would have to consider reform of the exit charge.

The Minister indicated that "South Africa's economy must grow faster and more inclusively". In addition, he indicated that "future growth is dependent on private sector investment in the economy." The above statement will be contradicted and eroded should the proposal be passed. The reasons are set out below:

- The current system where foreign employment income is exempted (subject to the requirements being met) is widely used by 26 nations of the OECD e.g. Australia, Germany, Canada and the United Kingdom etc. The removal of the current legislation

pertaining to the granting of a foreign earned employment exemption would be a step backwards for SA and will have an impact on the South African economy.

- The change in the legislation could result in South Africans not being used on foreign projects and preference given to foreign nationals, due to the initial increase in tax cost. This could result in a definite stagnation of in "Knowledge" base (borne out of skills and experience) as South Africans will not be exposed to ground breaking initiatives outside of South Africa.
- Potential outbound assignees would be discouraged from going on assignments if they are forced to continue paying taxes in South Africa and potentially the host country
- South Africans that are highly skilled are likely to emigrate. This will result in a critical skills shortage which would result in the movement of more foreigners into South Africa to plug the skills shortage.
- It will no longer be easy to conduct business in South Africa (for companies that use South African nationals).

All of these factors will have a direct impact in the economy. It would also erode confidence in government

The facts around the movement of employees

It is predicted as per the Ernst and Young's Global Mobility Survey of 2012 that short-term assignments are expected to increase by 20% and long term by 11% in the next two years. From these statistics it is important to see that cross border tax regimes need to be globally aligned to ensure the ease at which countries do business with each other, but at the same time are able to claim their rightful taxes due to them in a manner that is fair to individuals on assignments.

In the Global mobility survey the companies that took part in the poll highlighted that tax compliance is one of the top mobility challenges experienced by individuals. In changing our current policy on foreign earned income, it could pose numerous negative effects especially since foreign assignments are becoming a more frequent occurrence with South African residents employed in large global firms.

The survey went on to show the percentages of outbound assignments that are over 12 months are:

Brazil - 46%
Russia - 50%
India - 42%
China - 44%
Africa - 47%

From these figures we can deduce that there are a number of South African residents working abroad on assignments longer than 12 months. With the proposed change to a foreign tax credit system, this could cause an enormous administrative burden for both home and host countries. The taxpayer would be disadvantaged in terms of cash flow problems where tax years of the host and home country do not coincide in the same periods. We wish to thank Ashleigh Salmon and Vedika Andhee of Ernst & Young Advisory (Pty) Ltd for the detail above.

We have aligned ourselves with global trends of first world countries in order to make doing business with South Africa attractive and enable South Africa to expand and grow. Over 26 countries currently utilise a similar system as South Africa in providing an exemption for foreign earned employment income. The removal of this system would be a step backwards for South Africa.

The worldwide tax system erodes the principles on which a good tax system is based on, namely equality, it is certain and not arbitrary, convenience and efficiency (Adam Smith's maxims of a good tax system). With these principles in mind it is clear that the worldwide tax system is not equal, nor fair it is not convenient as a result of the administrative compliance burden and as a result of this it is certainly not efficient.

While section 6*quat*/ 6*quin* credits would be available in the absence of an exemption, these are far more complex to claim and also entail a serious cash flow disadvantage, since the taxpayer must pay in the host country and wait for a refund in the home country (if they remained on SA PAYE), or pay in both countries then amend the home country return later. We note that SARS is very slow to pay refunds and/or allow amended 6*quat* returns (taxpayers can wait up to 2 years). Employers often bear this cash flow expense via interest free loan benefits and/or grossing up the earnings/loan benefit. The cost to employers of investing abroad, which always involves sending employees abroad, will increase significantly.

Cross-border pensions

South African residents working abroad and foreign residents working in South Africa regularly contribute to local and foreign pension funds, which gives rise to a variety of tax issues. While certain limited rules have long been in place, these rules are largely ad hoc. With overall retirement reform now in effect, cross-border pension issues need to be fully reconsidered. The main issue is whether the tax focus should rely solely on the national source of the services provided or the national origin of the pension fund serving as the savings vehicle.

With the globalisation of all economies, it would be considered irresponsible of any employer to not contribute to employees' retirement savings. Accordingly, much like medical aid, where the fund is positioned should not be relevant as an off-shore fund could pay a retiree who has relocated to South Africa.

It would be more beneficial to allow a deduction to any retirement fund local or off-shore and tax payouts from the funds instead, irrespective of where the fund pays out from. (Essentially, a deeming source provision if in SA for more than a certain period of time regardless of where services during contribution were rendered) - section 10(1)(gC) may however need to be reconsidered.

The above may be unattractive to retirees but beneficial to globally mobile executives.

The current exemption of foreign- earned pensions is practical, logical and provides certainty. It should be extended to lump sums, as there is no reason to distinguish from a policy perspective.

Taxpayers have made very long term decisions based on the current rules and radical change should not be made lightly.
Treasury must also be mindful of anti-discrimination clauses in most treaties.

Foreign pension contributions

Taxing employer contributions to foreign pension plans, in the case of inbound expatriate workers, would be a massive cost to employers. These expats are typically tax equalised and the employer would be forced to gross up the 'benefit'. This cost would discourage foreign investment in SA, contrary to government policy, and would reduce the number of expats and skills transfer. SA would be a far less attractive destination in Africa.

VAT apportionment

The relevant statement in this regard is found on page 196 (Annexure C) of the 2013 budget.

It is under the heading "Apportionment – non-financial sectors'" and states the following:

> "The default apportionment method, which is based on turnover, appears to be inequitable at times because there may not be a direct correlation between expenditure incurred versus turnover generated. It is proposed that the default application of this method be re-evaluated".

In a submission made by SAICA to National Treasury and SARS **(attached),** SAICA highlighted the problems that many vendors experience with the prescribed turnover-based apportionment formula and particularly the inclusion of "c" in the formula. We attach a copy of our submission for a better understanding of the issue.

The vendors that are mainly affected by the inclusion of dividend income in the denominator of the prescribed turnover-based formula are head quarter companies and operating holding companies. We trust that the non-financial sectors referred to by the Minister include the vendors that SAICA referred to in its submission.

In order to overcome the practical difficulties described above which vendors experience with regard to the treatment of dividends (and similar passive income) in the standard prescribed turnover-based method of apportionment, SAICA proposed that consideration be given to prescribe by Regulation the formula with the exclusion of dividends (and similar passive income) from the denominator, in accordance with the world-wide treatment of such income.

Restricting debt to prevent base erosion

The Minister's comment in this regard reads as follows:

> "Although debt financing is a feature of all healthy economies, debt is often used to erode the tax base. Closure of artificial and excessive debt has been on the tax policy agenda for more than two years".

The relevant comment in the 2012 budget reads as follows:

> "To address these concerns, government will enact a revised set of reclassification rules deeming certain debt to be equivalent to shares. In 2013 government will also consider an "across the-board" percentage ceiling on interest deductions, relative to earnings before interest and depreciation, to limit excessive debt financing".

The specific proposals in the budget do not contain sufficient detail of the anticipated amendments to the Tax Legislation. In this it appears that case the law will in the first instance have to define the excessive portion of debt and then how the 40% limit is to be applied. It is expected that this will again result in complex tax legislation. This is quite common when anti-avoidance legislation is drafted. The consequence of this is that in most cases such legislation affects legitimate debt adversely. Our previous comment earlier in this document regarding tax avoidance is again relevant: tax avoidance should be dealt with in terms of tax avoidance legislation and not by complex law which aims to prevent specific tax savings.

With the current proposals regarding "Non-retirement savings" and the tax exempt interest being phased out one of the current concerns will eventually disappear.

Clarity needed on Transfer Pricing Practice Note

'Transfer pricing' is the term used to refer to the prices at which goods and services are transferred, cross border, between multi-national connected parties. To gather much needed taxes, Governments around the world are scrutinising the transfer prices charged between the entities in global multi-national groups, in order to make sure that they are recouping their fair share of the tax on the global profits.

The South African Government is no exception.

Transfer pricing legislation was first inserted into South African tax legislation in 1995. It was 1999, however, before any guidance was given as to what the legislation required and, even

then, it was limited to what interest could acceptably be paid on loans from offshore connected parties. This guidance, known as practice note 2 (PN2) introduced a so-called safe harbour rule, in that it advised that interest at a rate not exceeding prime plus 2% could be paid on financial assistance (i.e. a loan) from an offshore investor of up to three times the investor's fixed capital, without fear of reprisal. This latter requirement- 3x fixed capital- is known at the thin capitalisation safe harbour. Thus, investors had certainty that provided that they stayed within these rules, they were complying with the South African tax authority's requirements.

Over the years, due to changing accounting practices, it has become more difficult to determine what fell into the 'fixed capital' and 'financial assistance' parts of the safe harbour thin capital ratio, and calls were made for a revision of PN2 to clarify the latest position.

The legislation for transfer pricing was, however, overhauled and reintroduced during the course of 2012, and the changed legislation will affect many groups' 2013 tax years. The new legislation does not contain a thin capitalisation requirement, and some believe that PN2 is no longer relevant. However, the South African Revenue Service (SARS) has not withdrawn PN2 and, despite indications that new guidance has been in the process of being prepared, nothing has been issued. This leaves the South African taxpayer, who is a party to such loans, in a quandary as to what to do.

Must it look to international guidelines to determine what level of interest will be acceptable? If it does so, will SARS be satisfied with this approach? Does the fact that PN2 has not formally been withdrawn, and no alternative guidance offered, mean that SARS expects the 3x fixed capital rule not to be exceeded? On the other hand, if the taxpayer applies the 3x fixed capital rule, in line with PN2, will this continue to provide the security that the requirements have been complied with.

This lack of certainty as to what is acceptable to comply with the rules is symptomatic of a number of areas of our legislation. Since certainty is one of the basic principles on which tax legislation must be built, it is a serious flaw in our current transfer pricing, since taxpayers need to know how to make sure they are paying the right amount of tax i.e. to satisfy the transfer pricing legislation. Not knowing what to do leave taxpayers who want to do the right thing in the uncomfortable position that they don't know what the right thing is.

Transfer pricing rules always involve international participation. Thus, if South Africa wants to attract investment the rules must be clear.
SAICA hoped that mention will have been made of how this uncertainty is to be dealt with in the National Budget presented by Minister Pravin Gordhan on 27 of February, as the current position cannot to be allowed to continue.

In the meantime, it is to be hoped that SARS will not penalise taxpayers who take a reasonable decision to either follow international guidelines or follow PN2. Taxpayers should not be made to pay for shortcomings in legislation or the guidance thereon.

We again wish to thank the Chairpersons of the Finance Committees for this opportunity to provide our comments. If there are any questions with regard to our comments we will gladly answer them.

Yours faithfully

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