Standing Committee on Finance
Parliament of the Republic of South Africa
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Chair, Members,

Budget 2013 Tax Proposals – Preliminary Comment

1. We present herewith our initial commentary on the Tax Proposals included in the 2013 Budget Review.

2. As always, we remind members that tax legislation is notorious for having the proverbial "devil in the detail". As such, we may remain silent in respect of certain proposals that subsequently turn out to be objectionable or laudable, or we may commend ones that end up less favourable than initially anticipated, or we may oppose some that perhaps turn out to be less harsh than expected. We therefore eagerly await the actual text of draft legislation before submitting more comprehensive comment.

A. Overall

3. There is little doubt that the 2013 Budget was the toughest in many years given slowing economic growth, pressures on revenue collections, competing demands for expenditure and increasing debt levels. The Minister faced difficult choices. Given the slower economic growth, consequent lower revenues expected in 2013/14 and the need to reduce the budget deficit, he could either have increased taxes or trimmed government expenditure. We are pleased that the Minister made the bold decision to choose the latter, particularly insofar as non-performing programmes are concerned.

4. We generally consider the 2013 tax proposals to be welcome. In particular, we are pleased that no significant tax increases have been proposed

5. We set out below our more detailed comments.

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B. Proposals that are welcomed

Individuals

Personal income tax relief

6. Personal income tax relief of R7 billion was granted to individuals. This relief was relatively evenly distributed across taxpayers at all income levels. Although the relief didn't quite compensate fully for the effects of fiscal drag, given the pressures on tax revenues, it was welcomed and, in some respects, unexpected, particularly for higher-income earners. The relief will go some way to easing the pressures on consumers from rising costs and the increasing debt burden that many lower and middle income earners find themselves in. An increase in the tax burden on individuals would have had the effect of reducing household disposable income and a corresponding dampening effect on the largely consumer driven growth in the economy.

Retirement reforms

7. The further simplification of the tax proposals for retirement fund contributions is welcomed.

8. However, it should be noted that we still have some concerns with the proposed monetary cap discussed below.

Tax-preferred savings and investment accounts

9. We are supportive of the introduction of tax-preferred savings and investment accounts. South Africa has an exceptionally low rate of household savings and any incentives that encourage households to save are to be welcomed. We also welcome the proposal to now leave the interest exemption intact.

Employment tax incentives

10. The proposed youth employment tax incentive is welcomed as a long overdue means to increasing youth employment. We look forward to further details of how the incentive will operate.

Business

Relief for small business

11. We welcome the changes made to the progressive income tax rates for small business corporations and the increased turnover threshold for qualification. These changes will go some way towards relieving the tax burden on small business and freeing up resources for growth.

Special economic zones

12. We welcome the proposals for tax incentives for special economic zones. These incentives have the potential to act as a significant attraction for the establishment of new businesses.

13. However, we caution that tax incentives can never act as a cure for other shortcomings. It is therefore crucial to ensure that the special economic zones as a package are attractive to investors.

Anti-avoidance rules for deduction of interest

14. As a general matter, we welcome the proposal to introduce legislation regulating the deduction of interest. This issue has resulted in significant uncertainty over the last 2 years and it is important to replace the discretionary and subjective approval regime currently in place with clear and objective rules.

15. We look forward to engaging with National Treasury on the detail of this proposal.

Employment share schemes

16. We tentatively welcome the proposals to revise the tax treatment of share schemes. In particular we welcome the proposal to eliminate the anomalies potentially resulting in double tax and the potential for employers to obtain deductions in relation to share schemes.

Share cross issues

17. Share cross issues have long been a headache for business, particularly with respect to funding of empowerment transactions. We welcome the proposal to rework these provisions.

Gateway subsidiary

18. We welcome the proposal for listed multinationals to treat a subsidiary as a non-resident for exchange control purposes and to use functional currencies for tax purposes. However, we are not convinced that these proposals go far enough to encourage such groups to bring treasury functions onshore. We look forward to engaging with National Treasury in this regard.

Indirect tax

Certified emission reductions tax incentive

19. We welcome the extension of this incentive to 2020.

VAT registration of foreign businesses

20. We applaud the efforts to bring imported services and digital supplies into the VAT net. However, caution will need to be exercised to ensure that, firstly, the law can be enforced and that, secondly, the administrative burden placed on taxpayers and the costs of enforcement do not outweigh the benefits.

Tax administration

Streamlining registration and filing

21. We welcome the proposals to implement a single registration process and to streamline the VAT registration process. This is long overdue as the VAT registration process in particular has been a significant impediment to starting a business.

Tenders and tax compliance

22. We welcome the pending introduction of the automated tax clearance certificate provided that it does not completely replace human intervention in the event of discrepancies needing to be resolved.

C. Areas of Concern

Individuals

Cap on deductible retirement fund contributions

23. We remain strongly opposed to any monetary caps being placed on deductions for contributions to retirement funds. Although we have made submissions to National Treasury in this regard, we believe that these have not been adequately addressed and we repeat our concerns on this matter.

24. In summary, we assert that the proposal (*inter alia*):

    - adds unnecessary complexity into the tax system;
    - will *not*, in fact, have the effect of introducing more equity into the system;
    - will not necessarily lead to an increase in savings levels and may in fact reduce savings; and
    - should be considered in the light of international comparison,

25. Our commentary on this matter is set out in more detail in the attached Annexure.

Scrapping the conduit principle for trusts

26. It is not clear to us what specific policy or equity objective this proposal seeks to achieve or what specific tax avoidance concern it seeks to address. On the face of it, we would oppose this proposal in the absence of information as to how this principle leads to abuse.

Business

Withholding tax on service fees

27. We are uncertain of the logic behind the proposal to introduce a withholding tax on service fees. As a general matter, any such fees paid to residents of countries with whom South Africa has a double tax treaty will not be taxable in South Africa in terms of the treaty. This is because service fees are generally not specifically catered for in tax treaties and, as such, they are dealt with under the business profits provisions of treaties.

28. In order for the source country to have any taxing rights to business profits, it is necessary for the recipient to have a place of business in the source country to which those profits relate. As a general matter, service fees paid to a non-resident do not often attach to a place of business in South Africa. In any event, if they did they would be subject to income tax.

29. South Africa has concluded numerous tax treaties, including with most of the countries to which service fees would generally be paid. The result is that in practice the introduction of the new tax is unlikely to result in significant tax revenues —whilst increasing administration for both taxpayers and SARS— so the logic for its introduction would have to be questioned.

Indirect tax

Carbon Tax

30. We remain concerned at the potential implications for the introduction of a carbon tax on economic growth and job creation. Unfortunately, the Budget contains insufficient information on the latest proposals on which to provide meaningful comment at this time and we await the updated policy paper in this regard before making further comment.

31. Perhaps as a more fundamental matter, however, we remain concerned that the question of the appropriateness of a carbon tax (in principle) for changing emissions behaviour, particularly in highly regulated and monopolistic sectors such as electricity and oil, has not been fully aired. We remain of the view that a fuller debate of alternatives to the carbon tax has not yet run its course.

RAF levy

32. We remain concerned that we continue to see significant annual increases in the Road Accident Fund Levy. This levy has increased by significant amounts over the years and it is concerning that taxpayers continue to have to fund the deficit in this fund with little feedback on the progress in restoring it to solvency.

D. National Treasury Drafting Resources

33. As a final matter, we take this opportunity to commend National Treasury. Highly complex concepts are constantly being addressed under stressful time pressure. However, it is also obvious that the team is under-resourced with the result that sometimes inadvertent anomalies and errors creep in. given that there have been changes in the drafting team since the 2012 amendments this problem is likely to become more manifest. While this is unavoidable to some extent, the majority of the problems can be avoided by limiting the extent of complex changes that are undertaken.

34. The problem is made more acute by the limited time available for tax advisors and taxpayers to consider and comment on the proposed legislation and the small pool of such persons that actively participate in the development of our tax legislation. It would also be useful if further comments were sought where the draft legislation has been significantly amended after the original draft legislation has been issued.

35. In light of this, while we acknowledge the need for many of the proposals contained in this year's Budget, the likely complexity of a number of these proposals is of concern.

36. We are in desperate need for a period of consolidation in order to allow for tax advisors, taxpayers and SARS to get to grips with the numerous recent complex amendments and to correct the technical errors and anomalies that have arisen. Consideration should be given to postponing some of the more complex and less pressing proposals and having a longer period for consultation in this regard.

37. Important policy projects are also being delayed because the team is overburdened by the day-to-day workload.

38. A case in point is the Income Tax Act (ITA) re-write project. The current ITA was last consolidated and re-written 51 years ago, i.e. in 1962. There is little difference of opinion that the current ITA is desperately (and urgently) in need of a rewrite. National Treasury's current re-write project appears to have commenced some 6 years ago, but progress has been slow. As mentioned, the main reason for this delay appears to be the resource constraints at National Treasury.

39. Apart from the re-write project, there are several other initiatives that taxpayers are seeking, but which are being hampered by the resource problem.

We thank you for the opportunity to offer our opinion on the Budget, and we trust that you find this to be of assistance in your deliberations. Please do not hesitate to call on us for further analysis.

Yours sincerely,

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ANNEXURE

Concerns on cap on deductible retirement fund contributions

Model of taxation of retirement savings

1. The general model of taxation adopted for retirement savings in South Africa is the exempt, exempt, tax model, i.e. income used to contribute to retirement funds is exempt from personal income tax (indirectly through a deduction for contributions), growth in the retirement funds is exempt in the hands of the funds and withdrawals from retirement funds are taxed.

2. The proposed cap effectively introduces a dual model of taxation of retirement savings, the above for contributions below the cap and a tax, exempt, exempt/tax model for contributions above the cap where the income from which contributions are made is taxed and relief is given at the time of withdrawal from the retirement fund for non-deductible contributions, although the growth in the fund is taxed on withdrawal.

3. This dual model adds unnecessary complexity to the system.

The equity argument

4. The rationale advanced for placing a cap on deductible retirement fund contributions is to improve equity in the tax system. However, far from improving equity in the tax system, a cap will actually result in higher-income earners making contributions in excess of the cap being treated inequitably for the reasons set out below.

5. As a starting point it should be appreciated that the granting of deductions for contributions to retirement funds does not serve as permanent relief from tax, but rather, in general, defers tax to a later date when amounts are withdrawn from the fund (the exception is in relation to lump sum withdrawals where a portion is tax-free, although this is irrelevant in relation to contributions in excess of the proposed cap as these amounts are likely to be taxed at the maximum marginal rate of 40%).

6. The implication of the proposed cap is that the same rationale is valid to the tax deductibility of contributions to retirement funds as is applicable in the case of, for example, contributions to medical schemes where there is no deferral of tax, but rather permanent relief. The fundamental difference between contributions to retirement funds and contributions to medical schemes is that contributions to retirement funds are savings which will be taxed at a later date, whereas tax relief for contributions to medical schemes amounts to tax relief for consumption expenditure. To treat the two in a similar manner is to fundamentally misunderstand the difference. It is entirely equitable that higher-income earners should not benefit through the tax system for consumption expenditure at the expense of lower-income earners. However, this principle cannot apply to savings.

7. Any contributions below the thresholds will result in real relief from tax for the taxpayer. The deduction will be enjoyed now, but on withdrawal the taxpayer will be taxed on both the contributions and the growth thereon at rates applicable to income. However, in the case of contributions in excess of the thresholds no relief from tax will be enjoyed at the time of the contributions. Instead, we understand from the proposals, relief for non-deductible contributions will be given to the extent of the nominal amount of such contributions when withdrawn, either in the form of a lump sum or as a compulsory annuity.

8. The above is best illustrated by way of a simple example. Assume that a taxpayer makes a contribution of R1 000 to a retirement fund. The investment grows at an inflation rate of 6% per annum and is withdrawn 15 years later on retirement.

   - If the taxpayer obtains a deduction at the time of the contribution, he or she will enjoy real tax relief on R1 000 and will be taxable on a nominal amount of R2 397 in 15 years time. The real value of that amount in 15 years time is R1 000 today and the taxpayer will therefore ultimately pay tax on an amount of R1 000 in real terms and will be neutral in that regard.

   - However, if the taxpayer does not obtain a deduction at the time of the contribution, but instead is relieved from tax on the nominal amount of R1 000 at the time of the withdrawal, the taxpayer will pay tax on R1 000 at the time of the contribution and will pay tax on a nominal amount of R1 397 at the time of the withdrawal. In real terms, the amount of R1 397 equates to R583 with the result that the taxpayer suffers tax on an amount of R1 583 in real terms in comparison to the taxpayer that enjoyed a deduction for the contribution. In other words, the taxpayer who only enjoys relief on withdrawal is taxed on inflationary growth and is left worse off in real terms when compared to the taxpayer who gets a deduction for retirement fund contributions. The result is that the taxpayer who did not enjoy the deduction is treated inequitably compared to the taxpayer who does enjoy the deduction.

9. The argument that higher-income earners' deductible contributions should be capped because they enjoy greater relief than lower-income earners as a result of the progressive tax rates is also not valid as a result of the deferral nature of relief for contributions to retirement funds. Higher-income earners may enjoy tax relief at a rate of 40% for contributions to retirement funds as compared to lower marginal rates for taxpayers with incomes below the top tax bracket; however, these higher-income earners will also be taxed at higher rates when these amounts are withdrawn from the fund. Amounts withdrawn in the form of an annuity are taxed at marginal rates of up to 40%.

10. National Treasury suggests that the deduction regime for contributions to retirement funds is an incentive. While this is true to some extent, it is not entirely an accurate representation. The regime is merely a mechanism whereby the taxation of retirement savings is deferred until withdrawal of the savings. This, however, comes at a price as the withdrawal of the funds will be taxed at income rates. This should be compared with the

situation where savings are made outside of the retirement fund system. In such a situation, the bulk of the investment return would be taxed at the lower CGT rates. This is particularly the case insofar as equity investments are concerned and where the bulk of long term savings should ordinarily be invested.

11. Of course, if amounts will never be withdrawn from a retirement fund because the contributions are in excess of what is required in retirement, the deduction for such contributions effectively amounts to an indefinite deferral and could be regarded as an abuse of the regime. However, to suggest that contributions in excess of the monetary cap is tantamount to an abuse of the regime by that reason alone is a gross exaggeration. While it is acknowledged that the regime is open to abuse in exceptional circumstances through excessive contributions, as a general rule it is rarely abused by higher-income earners and only the ultra wealthy can afford to make contributions to retirement funds far in excess of their retirement needs. It cannot be suggested that reasonable contributions to retirement funds proportional to an individual's earnings amounts to abuse of the regime. Such contributions are directed merely at preserving such an individual's lifestyle in retirement. This is hardly an abuse.

12. The percentage based threshold is adequate to counter any perceived abuse related to excessive contributions.

Perverse incentive not to preserve retirement savings

13. As tax relief on non-deductible contributions is deferred until withdrawal and there is no preservation of the real value of those deductions, as illustrated above, there is a perverse incentive to withdraw retirement funds early in order to access the deduction and thereby preserve the real value of contributions from a tax perspective. For example, where an employee with accumulated non-deductible contributions of R300 000 changes jobs, it would be a reasonable and rational course of action for the employee to withdraw that amount from retirement savings. Such a withdrawal is tax free and the employee could then invest those amounts in savings regimes outside the formal retirement savings industry, e.g. by investing the amount in unit trusts. The tax incentive to do so extends beyond merely accessing the non-deductible contributions, but also extends to the more favourable tax rates applicable to capital gains compared to those on withdrawals from retirement funds.

14. By way of illustration, if the employee in the above example withdrew the R300 000 from a retirement fund tax free and invested the amount in unit trusts providing an annualised gross return of 9% per annum for 10 years, the tax on the growth in that investment in the form of CGT at the end of the investment period (assuming the return in the form of dividends and interest is negligible) would amount to R54 557 at an effective rate of 13.3%. This is compared with the tax that would be paid were that amount to be withdrawn from the retirement fund after 10 years, in which case tax of R147 675 would be paid at a rate of 36% (assuming the withdrawal is taxed at the maximum rate).

15. This perverse incentive runs counter to one of the key objectives of the package of retirement reform measures, being the improvement of preservation of retirement savings. While, in our example, the level of savings is not impacted, it must be borne in mind that these savings now fall outside the formal retirement savings sector and can be withdrawn at any time, with consequential implications for preservation.

The impact on retirement savings

16. South Africa has an extraordinarily low net household savings rate which stood at -0.2% in the first quarter of 2012. A low savings rate has the implication that more reliance has to be placed on foreign borrowings at higher interest rates in order to fund infrastructure projects and other expenditure, translates into higher costs of production and reduced competitiveness. Ultimately, lower savings rates translate to lower growth rates and lower growth rates translate to fewer jobs. Given South Africa's exceptionally high unemployment rate it is essential that everything is done to improve savings levels and certainly no steps should be taken that potentially negatively impact on savings.

17. It is therefore imperative that any steps taken to reform retirement savings have the added effect of promoting savings and, more importantly, do not act as a perverse incentive not to save or to save outside of the retirement funding system.

18. We are concerned that the proposed cap to be placed on deductible contributions to retirement funds will constitute precisely such a perverse incentive or, at best, will result in reduced levels of saving and a switch to alternative savings vehicles that are not specific to retirement and do not have the benefit of forced preservation, with the result that such savings could be reversed at any time. Ultimately, this could lead to even lower levels of household savings in the economy.

19. While this measure is aimed at limiting the deduction of retirement fund contributions for higher-income earners, in our view it will have a detrimental impact on the savings levels of those persons. Higher-income earners are precisely those persons that can most afford to save and they should be encouraged to save as much as possible, this ultimately being in the best interests of the country as a whole. The cap effectively sends the message to higher-income earners not to save more than the capped amount for retirement and will reduce the amount that such persons contribute to retirement funds.

20. The result is that many taxpayers are, in the absence of tax relief for contributions, likely to curtail their contributions to retirement funds. In fact, this would be a perfectly logical and rational thing to do for the reasons set out below.

21. A person who is contributing R1 000 to a retirement fund from after-tax income (disposable income) of R1 000 as a result of tax relief enjoyed under the current dispensation will face a significant impediment in the event that they become subject to a cap. Such a person's disposable income will be reduced by 40% as a result of the tax suffered on the income out of which the contribution is made. If our hypothetical taxpayer is to maintain the contribution of R1 000 to the retirement fund they will have

to do so out of a disposable income that has been reduced by R400. The result is that many higher-income earners will have to reduce their contributions to retirement funds as a result of a reduction in their disposable income. For example, our hypothetical taxpayer may have to reduce the contribution to the retirement fund to R600 in order to maintain existing consumption spending power.

22. Alternatively, taxpayers could suspend any contributions to retirement funds in excess of the cap and invest in alternative savings vehicles such as collective investment schemes where returns will largely have the benefit of being taxed as capital gains at lower rates than withdrawals from retirement funds being taxed at high rates. As illustrated above, there is a tax benefit to investing outside of retirement funds if no deduction is provided for the contributions due to the returns being taxed at much lower rates. It would therefore be irrational for taxpayers to contribute amounts to retirement funds in excess of the cap as they would be better off investing outside of retirement funds.

23. The result is that contributions to retirement funds will inevitably be reduced as a result of the cap with consequential implications for the savings rate and level of savings in the economy.

24. At worst, the cap could see higher-income earners not seeing any benefit of saving amounts in excess of the cap and instead spending the amounts, leading to increased consumption expenditure and even worse savings levels in the economy.

25. While National Treasury has attempted to dismiss these concerns as invalid or as likely having a negligible effect on savings, in our view the reasoning in this regard is flawed. We address each of these arguments below.

26. Firstly, National Treasury notes that non-deductible contributions will be rolled forward to subsequent years and ultimately withdrawals will be exempt from tax to the extent of such non-deductible contributions. However, as noted above, the real value of these non-deductible contributions is not preserved with the effect that it is more beneficial to invest amounts in excess of the deductible contributions outside of retirement funds due to the lower tax rates applicable to such investments. Investments in retirement funds are not competitive in the absence of an upfront deduction as withdrawals are taxed at rates applicable to income, in effect resulting in gains on capital investments in retirement funds being taxed at far higher rates than those applicable to other savings vehicles.

27. Secondly, National Treasury attempted to analyse the expected impact and draw conclusions on the likely impact on savings from SARS statistical data relating to contributions to pension funds and RAFs. However, this analysis is fundamentally flawed and the conclusions drawn are dangerous for the following reasons:

    - The SARS statistics contain no information with regards to contributions to provident funds. According to the discussion paper "Enabling a better income in retirement", defined contribution provident funds have nearly 4.5 million members

and have assets under management of R308 billion. The membership of such provident funds is more than double that of defined contribution pension funds and about 25% more than RAFs. If defined benefit funds were to be included these numbers would obviously increase further. The number of members of defined contribution provident funds alone is roughly equivalent to the number of taxpayers according to SARS statistics. Were contributions to provident funds to be taken into account, this would likely substantially increase the average contribution for taxpayers who earn in excess of R1 million per annum.

- The manner in which the average contributions of taxpayers has been determined is flawed. In reality it is entirely possible that the range of deductions could be extremely broad with lower contributors significantly skewing the average. This is particularly likely in the case of contributions to RAFs where, unlike pension funds and provident funds which generally have minimum contribution rates, no minimum contribution rates apply.

- The discussion document fails to take into consideration that many taxpayers contribute to more than one type of retirement fund. For example, many employees supplement their retirement savings in pension or provident funds with further savings in RAFs. This is readily apparent when consideration is given to the proportion of taxpayers earning in excess of R1 million who are members of pension funds or RAFs. This equates to 72%. Given that the membership of provident funds is at least equivalent to that of pension funds, when these are taken into consideration the aggregate percentage is likely to be well in excess of 100%. It is therefore flawed to consider contributions to each type of retirement fund individually.

- The discussion document assumes that the amounts reflected in the tax statistics relate to deductions for contributions to retirement funds claimed. This is, however, incorrect. The amounts reflected in the tax statistics relate to deductions allowed. As such, the actual contributions to retirement funds are likely to be substantially in excess of these amounts, particularly insofar as contributions to RAFs are concerned.

28. The conclusion by National Treasury that the cap is not likely to have a significant effect on savings levels is therefore not supported by any valid evidence.

29. Even if the conclusions reached by National Treasury are correct (and we doubt they are), it is extremely dangerous to make policy decisions that have a potentially negative impact on household savings levels without a full and complete understanding of the potential impact of those decisions.

30. Furthermore, it is submitted that, given South Africa's extremely poor levels of household savings, no policies that have a potentially negative effect on saving levels

should be introduced, regardless of how small the expected impact is. Doing so will simply serve to undermine other policy initiatives directed at increasing savings levels.

International practice

31. A glaring omission from National Treasury's discussion documents on this matter is any consideration of international examples of monetary caps placed on tax relief for retirement savings. Consideration should be given to how other countries with comparable systems of taxation of retirement savings treat contributions to retirement funds.

32. While it is difficult to find other countries with comparable retirement systems and tax regimes due to the widely varying nature of these, we have struggled to find many comparable regimes where a monetary cap is placed on tax relief for retirement contributions.

33. The one exception is the United Kingdom which places a cap on tax-relieved contributions to retirement funds. However, this cap is set at £50 000 (and was previously far greater). This equates to approximately R700 000 and is therefore double the cap proposed in the Budget. Furthermore, the UK does not have a percentage based limitation for tax relief on contributions to retirement funds and it is therefore possible to obtain a deduction of up to £50 000 if the taxable earnings are at least equal to this amount. The UK also allows unutilised contributions below the cap from prior years to be used against later contributions.

34. However, the UK also has a lifetime allowance of £1.5 million in terms of which withdrawals from retirement funds in excess of this amount are subject to an additional tax charge.

Roll forward of unutilised caps

35. It often happens that in some years caps are not fully utilised, but in subsequent years caps are exceeded. This is particularly relevant in the case of taxpayer's with volatile earnings and older taxpayer's who have to contribute at higher rates in order to compensate for low savings rates when they were younger.

36. An appropriate mechanism to address such a situation, apart from the higher allowed contribution rates for older taxpayers, is to allow unutilised caps from earlier years to be rolled forward to later years. For example, the UK allows unused annual allowances from the 3 previous years to be carried forward and used to increase permissible deductions in subsequent years. As another example, Canada allows a roll forward of unutilised caps extending back to 1990.