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National Treasury
Ms Adele Collins (South African Revenue Service)

Per email: 2019AnnexCProp@treasury.gov.za
acollins@sars.gov.za

Dear National Treasury and Ms Collins

SAICA COMMENTS ON THE DRAFT TAXATION LAWS AMENDMENT BILL AND TAX ADMINISTRATION LAWS AMENDMENT BILL OF 2019

The National Tax Committee on behalf of the South African Institute of Chartered Accountants (SAICA) welcomes the opportunity to make a submission to National Treasury (NT) and the South African Revenue Service (SARS) on the Draft Taxation Laws Amendment Bill (DTLAB19) and Tax Administration Laws Amendment Bill 2019 (DTALAB19). As opposed to prior years, where a single submission has been made, our submission this year has been divided into three parts, namely matters involving amendments to –

1. The Income Tax Act, 58 of 1962, as amended (the Act);

2. The Value Added Tax Act, 89 of 1991, as amended (the VAT Act); and

3. The Tax Administration Act, 28 of 2011, as amended (the TAA Act).

We have set out in detail in **Annexure A,** our comments in relation to the matters referred to point 1. above pertaining to the Act. We also set out in **Annexure B** additional matters that in our view should also be considered.

Please do not hesitate to contact us should you have any queries in relation to anything contained in this submission.

Yours sincerely

David Warneke

Chairperson: National Tax Committee

Pieter Faber

Senior Executive: Tax

The South African Institute of Chartered Accountants

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ANNEXURE A

GENERAL

Effective dates

1 The DTLAB19 indicates the proposed effective date in relation to some, but not all of the amendments. The Bill also does not have the usual wording at the end, stating "*Save in so far as is otherwise provided for in this Act, or the context otherwise indicates, the amendments effected by this Act come into operation on the date of promulgation of this Act*" (which wording is in the TALAB19).

2 Submission: The lack of an effective date for many of the proposed amendments creates uncertainty as it digresses from the usual approach. We recommend that this be addressed.

INDIVIDUALS, TRUSTS AND EXEMPT ENTITIES

Individuals & Employment

Section 3 of the Estate Duty Act – Retirement Annuity Fund contributions (Clause 1)

3 The proposal closes a "loophole" by introducing *retrospective* changes to the Estate Duty Act to prevent individuals from avoiding estate duty by a making large contribution into a retirement annuity fund in the year the individual dies.

4 Submission: The proposed amendment should not be retrospectively applied as it is unfair to punish individuals who, at that stage, legitimately contributed 'non-deductible contributions' for retirement planning purposes. This goes against the fundamental principle of certainty in tax legislation and undermines confidence in the legislative process.

Section 7B of the Income Tax Act – Extending the scope variable remuneration (Clause 3)

5 The proposed amendment to section 7B replaces defined specific types of payments constituting variable remuneration with generic characteristics. The objective of the proposed amendment is thus to expand the definition of "variable remuneration" to include other types of income, for example, night shift allowances and standby allowances paid by employers.

6 However, the proposed wording in subsection (iii) appears to limit rather than expand the definition of variable remuneration. Similar to the principle underpinning the concept of 'capital', the principle underpinning the concept of 'variable remuneration' as set out in the Explanatory Memorandum does not lend itself to precise description.

7 The numbering of the subparagraphs of the definition of 'variable remuneration' is incorrect. Subparagraph (iii) should be subparagraph (ii).

8 Subsection (a)(i)(aa), (bb) and (cc) of the proposed definition of variable remuneration includes the following amounts:

"3(1) …

(a) any amount of remuneration, as defined in the Fourth Schedule, to the extent that the amount of that remuneration—

(i) (aa) cannot be determined prior to the entitlement of payment of that amount;

(bb) the identity of the employee to whom the amount is payable cannot be determined prior to entitlement to payment of that amount; and

(cc) differs in respect of each month; or …"

9 In many instances involving variable remuneration, the amount of the remuneration would be capable of determination "*prior to the entitlement of payment*" of that amount. An example of this would be an employee who approaches an employer for permission to work two hours of overtime. Furthermore, subparagraph (aa) provides that an amount will fall within the definition of variable remuneration to the extent that the amount cannot be determined prior to the entitlement of payment of that amount. In order for an amount to fall within a person's gross income, it must be a determinable sum in the hands of the taxpayer.

10 Submission: Taking the above into account, we submit that subparagraph (aa) is superfluous.

11 It is also problematic to suggest that an employer cannot determine the identity of its employees. Furthermore, in instances where an employee is paid weekly or daily – the amount would probably differ in respect of each week or day, not necessarily in respect of "each month".

12 It is also uncertain why section 7B would not apply if the employee becomes entitled to payment of the amount two months after the month in which the approval is given, and not in the month after approval was given as set out in the Explanatory Memorandum. Payments to employees that are approved by the employer, for example, annual bonuses, are not always paid out in the month following the month in which the amount was approved by the employer. For example, the Remuneration Committee may approve the amount to be paid as an annual bonus to employees in say, October, with the intention of paying the bonuses to the employees in December. Since the timing for payment of the bonus will not coincide with the timing in subsection (iii) of the proposed amendment, it will not fall within the definition of variable remuneration and will accrue to the employee once the employee becomes unconditionally entitled to the amount. This could result in the

employer having to withhold employees' tax in respect of the bonus prior to receipt thereof by the employee.

13 An employer will usually be in a position to determine the amount payable to the employee where the employee works a standard number of hours per night while on night shift and is paid in accordance with a specific hourly rate. However, where employees work night shift or are on standby they may be paid their night shift allowances and/or standby allowances for the full month, only on the last day of the month. A problem arises for the employer where the payroll run takes place earlier in the month, for example, on the 25th of the month and the employer is unable to undertake a second payroll run to pay the employees' tax, Skills Development Levies and Unemployment Insurance Fund contributions over to the South African Revenue Service by the 7th of the following month, in respect of the night shift allowances and standby allowances paid to employees on the last day of the preceding month.

14 Submission: The proposed amendment should be reconsidered in favour of the status quo with the addition of defined categories of remuneration that it is sought to be included in section 7B. The principle underpinning the concept of 'variable remuneration' is not easily defined.

15 Should this not occur, the definition of "variable remuneration" should be amended to include any amount that is subject to approval by the employer prior to payment thereof, which is payable to the employee in *any subsequent month.*

16 We further suggest that the word "and" at the end of subparagraph (bb) be replaced by the word "or" in order to widen the definition of variable remuneration and take into account circumstances where the amount to be paid differs in respect of each month but the identity of the employee is known.

17 Where variable remuneration is paid to an employee after the 25th of the month the amount should be deemed to accrue to the employee in the following month. The employer will then be able to process the night shift allowances and standby allowances through the payroll in the following month without attracting penalties and interest.

18 The numbering of the subparagraphs of the definition of "variable remuneration" is incorrect. Subparagraph (iii) should be subparagraph (ii).

Exempt entities

30 and 30A – PBOs and Recreational Clubs (Clauses 34 and 35)

19 The EM states that the reason for the deletion of section 30(3B) and 30A(4) is to remove an obsolete transitional measure initially introduced to provide organisations

that were already exempt from the Act under the repealed legislation the opportunity to re-apply under section 30/30A of the Act.

20 This may have been the initial intention but we submit that such intention was changed in 2009.

21 According to the EM on the TLAB 2009, section 30(4) was introduced for the following reasons:

22 *"Many PBOs and clubs applying for exemption do so after several years of activity. This delay may stem from a lack of expertise or due to an over-emphasis on starting activities. Failure to seek prompt approval then keeps the relevant parties from subsequently seeking relief on a going forward basis because of concerns about the potential tax liability from pre-existing activities*".

23 This discretion, as amended in 2009, recognises the importance of especially PBO's in society and therefore made their retrospective approval subject to them having always benefited society by carrying on a PBA historically (i.e. it was merely a compliance matter). In fact, the discretion was widened to include both pre and post 2001 PBO's.

24 It appears as if the reasons for not registering for tax are currently still the same. However, if a PBO or Recreational Club only realizes that it has to register with the Commissioner after it has commenced operating (which is a regular occurrence), the current provisions (section 30(3B) and 30A(4)) empower the Commissioner to grant retrospective approval.

25 The majority of PBOs and Recreational Clubs are poorly resourced and do not have funds available for tax advice from the outset in respect of which is very complex legislation.

26 In the absence of these provisions, the organisations may be taxed as ordinary taxpayers and may in addition face understatement penalties. This will in turn undermine the public benefit objectives of such organisations. Alternatively, they will be required to go through the corporate tax cycle just to in any event end up in the exempt SARS channel which brings its own practical challenges regarding compliance history confirmations etc.

27 It is also our view that this will discourage especially PBO's from becoming compliant and they would therefore just abandon finished projects and never apply for tax compliance.

28 Submission: We do not condone non-compliance, however, the realities have to be considered in addition to the tax policy utopia. The proposed deletion of subsections 30(3B) and 30A(4) should be reconsidered, taking into account the function of these entities in society, the additional burden this will place on these organisations and

the fact that increases in time and tax costs will undermine the roles that these organisations play in society.

29 Should this proposal not be accepted, then at minimum, these organisations should be given relief from penalties and interest that arise as a result of the deletion of these subsections.

LOCAL BUSINESS TAXES

<u>Section 11(j)(aa)(B) – Grammatical error (Clause 15)</u>

30 Submission: The word “and” should be deleted as it appears twice after subsection (i)(aa)(B).

<u>Section 22 – Trading Stock (Clause 22)</u>

31 It is noted that there is no EM insertion relating to NT's thoughts around the amendments contained in Clause 22(b).

32 Submission: NT should provide the background and the reasons for this amendment as it is imperative to understand NT's thought process for this inclusion as this has far reaching practical implications in practice.

33 In light of the significant uncertainty caused by the ruling of the court in the SCA case C:SARS v Volkswagen S A (Pty) Ltd (1028/2017) [2018] ZASCA 116 (19 September 2018), we welcome the proposed amendments to section 22(1) of the Act, and specifically the addition of proviso (b).

34 Proviso (b) to section 22(1) states that "*any diminution in the value of trading stock must be determined on an item-by-item basis*”. The court’s view that the net realizable value of stock had to be determined in total and not on an individual item basis amounted to a significant deviation from long standing practice and would have had significant implications.

35 Without advocating for the determination of net realisable value to be determined on a total basis, we acknowledge that valuing items on an item by item basis will be impractical for corporations with significant stock levels. The current prevailing practice by SARS allows the reduction from closing stock if such a reduction is on a specific basis even if per category of stock (based on for example shelf-life, fashion, expiry dates) which is "broader", yet specific enough to ensure taxable income cannot be manipulated by diminution of stock levels.

36 Furthermore, the judgment in the SCA case C:SARS v Volkswagen S A (Pty) Ltd (1028/2017) [2018] ZASCA 116 (19 September 2018) in clause 45, referred to the

IAS 2 requirement that trading stock by valued on an item-by-item basis, unless otherwise impractical. The full extract from IAS 2 paragraph 29 reads as follows:

"Inventories are usually written down to net realisable value item by item. In some circumstances, however, it may be appropriate to group similar or related items. This may be the case with items of inventory relating to the same product line that have similar purposes or end uses, are produced and marketed in the same geographical area, and cannot be practicably evaluated separately from other items in that product line. It is not appropriate to write inventories down on the basis of a classification of inventory, for example, finished goods, or all the inventories in a particular operating segment."

37 Submission: In cases where it is impractical to value trading stock on an item by item basis, for example if trading stock consists of many identical items such as nails or sweets, it is submitted that it should be permitted to write down trading stock by group of similar or related items.

38 Unfortunately, despite the proposed amendment to section 22(1), taxpayers are still left with a significant amount of uncertainty as to whether the value of trading stock included in the determination of taxable income both as opening stock and closing stock will be acceptable to SARS.

39 Clarity is required as a matter of urgency. As the law currently stands, taxpayers will be required to determine the net realisable value of trading stock for accounting purposes as well as for tax purposes with no guarantees that the determination for tax purposes will be accepted by SARS. This is a significant burden on the taxpayer.

40 The cost of having to maintain separate tax and accounting valuations of trading stock is a burden on taxpayers that significantly adds to the costs of compliance.

41 Submission: It is recommended that section 22 be amended further to align the tax treatment of trading stock to the accounting treatment instead of the current situation in which taxpayers have to maintain separate records for accounting and tax purposes. Accounting principles have already been accepted elsewhere in the Income Tax Act (refer for example to sections 11(j) and 11(jA)).

Section 22B – Dividends treated as income (Clause 23)

42 Submission: We refer you to our submission, entitled "Comments on the initial batch of the draft Taxation Laws Amendment Bill 2019" for our views on the proposed changes to this section as well as our discussion on the changes to paragraph 43A further on in this document.

43 We remain on the view that the continual expansion in policy and scope of this provision is problematic and therefore unavoidably encroaches on legitimate transactions outside of the intended mischief.

Section 23C – Cost or market value of asset and VAT (Clause 24)

44 It is not only paragraph 7 of the Seventh Schedule where VAT is considered in determining the market value or cost of an asset. For example, paragraph 5 also refers to cost and to market value and paragraph 10 refers to cost.

45 The word 'notwithstanding' is inappropriate in the current context.

46 Submission: We suggest that the clause should read: "*Except for paragraph 7 of the Seventh Schedule, where regard is to be had…*"

Section 24BA – Assets acquired as consideration for shares issued (Clause 28)

47 The amendment in section 24BA refers only to IFRS and not IFRS for SMEs. The principles in IAS 12 would be the same for IFRS for SMEs.

48 Submission: We suggest that the reference to IFRS be extended to include IFRS for SME's.

49 Value 'mismatches' created by a deferred tax liability currently create a problem for taxpayers by potentially rendering transactions that are in all other respects conducted a value-for-value basis, subject to section 24BA adjustments. We also note that section 24BA is one of the transactions that specifically overrides the corporate restructuring rules. In view of this and the fact that the proposal was announced in the Minister's Budget Speech on 20 February 2019, we submit that the envisaged effective date of this proposal should be brought forward so as to apply to any acquisition on or after 20 February 2019, or if this is not acceptable, to 21 July 2019 (the date of release of the DTLAB).

50 Submission: The effective date of this proposal should be brought forward so as to apply to any acquisition on or after 20 February 2019, or if this is not acceptable, to 21 July 2019 (the date of release of the DTLAB)."

Section 24O – Deductibility of interest on debt (Clause 30)

51 The proviso at the end of subsection (3) appears to apply to the whole of subsection (3).

52 Submission: The proviso should only apply to subsection (3)(b) and not the whole of subsection 3.

53 The wording of the amendment relating to section 24O(5) refers to "in consequence of an unbundling transaction contemplated in section 46…"

54 Submission: It should be clarified whether the proposed wording "contemplated in section 46" means that the unbundling transaction must have been carried out in

terms of section 46 or whether it means that the unbundling transaction is merely an unbundling transaction as described in section 46.

55 As currently worded, section 24O only applies to debt used to acquire shares which acquisition results in the purchaser becoming a controlling group company in relation to the other company. If, for example, a company ("the taxpayer") acquires 72% of the shares in a company and all the other requirements of section 24O are met, the taxpayer is able to claim the interest incurred in relation to the debt utilized to finance the acquisition.

56 Should the taxpayer later on acquire the remaining shares (28%), that acquisition will not result in the taxpayer becoming a controlling group company in relation to the other company as the taxpayer is already a controlling company in relation to the other company. Therefore, the interest incurred in relation to the debt utilized to acquire the remaining 28% of the shares will not be deductible for tax purposes.

57 Submission: Section 24O should be amended to allow the deduction of interest incurred on debt utilized to acquire additional shares in a company, even if the taxpayer already controls the company before acquiring the additional shares.

Section 25BB – Taxation of REITs (Clause 31)

58 The inclusion of exchange gains and losses in the calculation of "rental income" is welcomed.

59 However, this treatment is not extended to exchange gains and losses arising in relation to exchange items taken out to finance property, for example mortgage bonds. Such exchange items are integral to the operations of a REIT.

60 Submission: The inclusion of exchange gains and losses in the definition of 'rental income' should be extended to exchange gains and losses arising in relation to exchange items taken out to finance property.

Section 41(2) – Exclusion of interest-bearing instruments and exchange items (Clause 38)

61 It is unclear from the draft explanatory memorandum why adjusted gains or losses on redemption or transfer of interest-bearing instruments, as contemplated in s 24J, and exchange items, as contemplated in s 24I, should be excluded from the corporate rules.

62 Unlike other provisions specified in s 41(2) that explicitly do not override the corporate rules (for example, value-shifting rules, GAAR, etc.), it is submitted that provisions relating to adjusted gains or losses on the transfer or redemption of interest-bearing instruments and deferral of exchange gains or losses are not anti-avoidance rules. These provisions merely govern the timing of when certain gains or

losses should be taken into account by a taxpayer. The policy rationale for excluding such timing provisions from the relief afforded by the corporate rules is unclear.

63 If the corporate rules do not apply to these items and roll-over relief is not afforded to these items until the gains or losses truly realise, reorganisation transactions will not be completely tax neutral. As a result, tax may become an obstruction to such transactions contemplated in ss 42 to 47, which the legislature intended to allow on a tax neutral basis.

64 Submission: It is recommended that the rationale for the proposed position of excluding these items from the roll-over relief be reviewed in light of the purpose of the corporate rules, and, if not revised, that the policy rationale for not enabling tax neutral reorganisations be clearly explained in the Explanatory Memorandum.

INCOME TAX: BUSINESS (INCENTIVES)

Special Economic Zones (SEZ)

Section 12R – Policy rationale and amendments (Clause 18)

65 SAICA acknowledges the concerns raised by NT in relation to this incentive and therefore supports NT's policy rationale in addressing such abuse. However, the manner in which this abuse is addressed should be undertaken in a very specific way and, most importantly, should not undermine investor confidence.

66 The requirement that a trade must not have previously been carried on by any connected person in relation to a qualifying company is not realistic. For example, if a non-resident company relocates some of its operations to a South African SEZ, this requirement will not be met.

67 The requirement that the gross income of a qualifying company must have increased by at least 100% when compared with the highest gross income derived in respect of that trade during any of the three years of assessment immediately preceding that date, is extremely stringent.

68 Per the proposed amendments to section 12R, one of the qualifying criteria applicable to companies that were carrying on a trade within an SEZ before 9 February 2016 is that "*operations of that trade were expanded on or after that date and as a result, the gross income derived by that company in respect of that trade increased by at least 100% when compared with the highest gross income derived in respect of that trade during any of the three years of assessment immediately preceding that date*."

69 Increases in gross income of 100% will most likely only be achieved in respect of completely new trades, in which case no companies currently operating within an

SEZ that were carrying on a trade within an SEZ before 9 February 2016 would meet this qualifying criteria for expansions.

70 This would especially be the case where companies have commissioning periods that occur halfway or towards the end of a year of assessment, whereby the products from the commissioning period can be sold, but the resultant gross income derived from these sales will be far less than when production is at its full capacity.

71 Submission: Turnover is dependent on many factors, including market volatility. The proposal, that only companies whose expansions result in a 100% increase in turnover, will be eligible for the beneficial tax benefits of a SEZ, is unrealistic and unreasonable.

72 In order to limit the negative effects on investor confidence, we recommend that the *average* gross income of the three years of assessment immediately preceding 9 February 2019 should be applied, rather than the highest gross income of a single year of assessment.

73 We also recommend that either:

74 1) the percentage increase in gross income be reduced to between 25% and 30% in the first year, with an overall 50% increase in gross income by that company in respect of that trade achieved within three years from the expansion of operations, or

75 2) a requirement that is not linked to gross income be considered (such as creating and maintaining jobs over, for example, a five-year period, or a sustained increase in production).

76 In addition, we recommend that guidance be given on how commissioning periods should be treated.

Section 12R – Technical issues

77 When defining a "qualifying company", paragraph (d) states that "*not less than 90% of the income of that company is derived from the carrying on of a trade within… special economic zones*". When determining this *income*, it is unclear whether foreign exchange gains/ losses should be included or excluded from this calculation. In addition, it is unclear whether the income for purposes of the calculation includes or excludes exempt income.

78 Submission: We recommend that a definition of "*income*" for purposes of this section be provided, or that "*income*" be expressly defined with reference to the definition already set out in section 1 of the Income Tax Act.

79 "Qualifying companies" as defined do not require pre-approval to benefit from the reduced corporate tax rate of 15% (other than meeting the required qualifying

criteria). As such, should a company meet the definition of a "qualifying company", it may benefit from the reduced corporate tax rate upon disclosure / election in its tax return that it constitutes a qualifying company as defined.

80 However, when attempting to apply the SEZ tax benefit, it is unclear whether companies require a letter from the SEZ operator as proof of meeting the "qualifying company" requirements, or whether the onus of proof is on the individual company.

81 Submission: Clarification on the above issues is requested.

82 Section 12R no longer specifies the reduced corporate tax rate of 15% within the section. This has been moved to section 3 of Schedule 1 of the Rates and Monetary Amounts and Amendment of Revenue Laws Bill, 2019.

83 Submission: We recommend that section 12R makes reference to a reduced corporate tax rate being applicable to qualifying companies and also where the reduced corporate tax rate percentage can be found.

84 The effective date of implementation of the proposed amendments to section 12R is 1 January 2019, however, there is uncertainty regarding how the effective date will be practically applied for companies who do not have a December year end and are no longer regarded as "qualifying companies", as defined, on or after 1 January 2019.

85 Submission: We recommend that guidance be provided as to how the effective date is to be practically applied when submitting tax returns i.e. how should companies who are no longer regarded as "qualifying companies" on or after 1 January 2019 apply the change in the corporate tax rate.

86 Currently, the section 12R provision ceases to apply "in respect of any year of assessment commencing the later of: a) on or after 1 January 2024, or b) 10 years after the commencement of the carrying on of a trade in a Special Economic Zone".

87 In effect, this paragraph would allow for the SEZ tax benefits to be available until 1 January 2034 (for instance, should a company have a December year of assessment and commence operations in an SEZ during December 2023).

88 Submission: It should be clarified whether this is indeed the intention of the legislation as it currently reads.

89 The SEZ Act sets out the duties of the Department of Trade and Industry (DTI) in terms of SEZs i.e. acting on the Advisory Board and reporting to Parliament. However, clarification is required as to whether the DTI has any further involvement in terms of monitoring the performance of the individual companies located within the SEZ, or whether this performance will be monitored on an individual basis solely by

the SEZ operators, with a consolidated performance/progress report being provided to the Advisory Board?

90 Submission: Clarification on the above issues is requested. It is, however, recommended that the DTI be involved in the monitoring of the performance of the individual companies located in SEZs. We also suggest that the DTI be involved in a pre-approval process for SEZs wishing to conduct businesses in an SEZ. Pre-approval of SEZs will give certainty to taxpayers that their entry into the SEZ is within acceptable boundaries and is much better than a post-hoc facts-and-circumstances analysis.

Venture Capital Companies

Section 12J – Rationale for changes (Clause 17)

91 The changes introduced to the 12J legislation in the 2018 TLAB were extensive, comprehensive, thoroughly debated, and generally well received by the industry and, in their opinion, successful in closing the opportunities for abuse.

92 However, the EM states as follows: "*Despite Government's efforts to introduce these anti-avoidance measures, it has come to government's attention that some taxpayers are still attempting to undermine the objectives and principles of the VCC tax incentive regime to benefit from excessive tax deductions*".

93 It appears that there is a significant information gap between the allegations of "rampant abuse" and actual abuse that may be taking place.

94 Submission: National Treasury is urged to provide information on the current status of VCCs in South Africa and the abuse as the role players do not believe that this correctly reflects the activities of the majority VCC companies and they would like to assist in preventing further abuse.

95 SAICA supports NT's policy rationale in addressing abuse of the incentive, however, the manner in which this abuse is addressed should be undertaken in a very specific way and, most importantly, should not undermine investor confidence.

96 Many legitimate venture capital funds were set up on the basis of the legislation as it currently reads and investors have locked in their capital for a five-year period. Introducing an incentive and after several years changing the basis of the allowance by once again introducing a limit to the deduction, will have a detrimental effect on the viability of existing VCCs that were established with the valid objective of investing in small businesses.

97 If enacted, the proposal will result in many existing VCC arrangements becoming non-compliant with the requirements of section 12J. While there was no limitation of the amount of the allowance, many large investments were made into VCCs that rely

on further large capital raises from other taxpayers within the following three years in order to comply with the section 12J requirements relating to connected persons and the 20% of shareholding. The imposition of the limit of R2.5 million will make such large capital raises practically impossible, leading to non-compliance with the requirements of section 12J.

98 This non-compliance will result in a penalty and the lack of confidence that this will engender will jeopardise future investments into VCCs and small businesses.

99 Furthermore, such a major change to the structure of the incentive will undermine investor confidence. If the proposal is accepted, there is little doubt that potential investors will think twice in future when evaluating any VCC investments or any other investments that are offered by National Treasury as tax incentives.

100 Submission: The effect on investor confidence should not be underestimated, especially in the tough economic climate in which South Africa finds itself. Having to continually modify business models to remain compliant does not provide policy certainty to investors who are seeking to improve economic growth and job creation.

101 Rather than limiting the tax deduction for capital investment into VCCs, limiting what a VCC can do with the investment money it receives should be considered as it seems the abuse is not the cash amounts but that it is not being used for what NT is attempting to incentivise.

102 We are not in favour of limiting the tax deduction for capital investment into VCCs, especially in view of the current state of investment in our economy. However, if there is to be a limit on the tax deduction for capital investment into VCCs, then the amount of R2.5 million per annum is too low to attract investors that could make a meaningful difference to our economy and should be increased significantly.

Section 12J - Carry-forward of amounts not deducted

103 The amendment proposes to limit the deduction allowed in respect of expenditure incurred by a person to acquire venture capital company (VCC) shares to R2,5 million during a year of assessment.

104 While an investor in a VCC may only benefit from a tax deduction of R2,5 million during the year in which the expenditure is incurred to subscribe for venture capital company shares, that investor may nevertheless invest a greater amount in the shares of a VCC. It is unclear from the proposed amendment whether any expenditure by an investor in a VCC in excess of R2,5 million during a year of assessment can be carried forward and qualify for deduction under section 12J(2) in a subsequent year of assessment or will be forfeited (i.e. treated like any other investment in shares of capital nature).

105 Submission: As noted above, in our view the proposal to limit tax deductions for investment in a VCC should be scrapped. If it is to be retained, then any excess investment over the limit should rank for deduction in future years of assessment.

Capital gains tax

Paragraph 43A of the Eighth Schedule to the Act and section 22B (Clauses 59 and 23)

106 Section 22B and para 43A have become dreadfully complex. The so-called 'mischief' that is sought to be addressed rests on a questionable foundation and is, in any event, outweighed by the increased cost to business of interpreting the provisions and monitoring whether or not ordinary transactions fall foul of them.

107 The declaration of dividends by a company and the issuing of shares by a company are hardly capable of description as 'abusive' transactions. If a dividend is declared by a company, the reserves in the company become part of the reserves of the shareholder company. In time, dividends tax will be collected when these reserves cease to form part of the reserves of a company. Therefore, the issue in question is a deferral of dividends tax, which is an exemption granted in the case of dividends declared by one South African resident company to another.

108 The declaration of dividends by a company, in fact, helps to eliminate the cascading effect of capital gains, where reserves in a company are taken into account more than once. That is, firstly in the valuation of the shares of that company and secondly, in the valuation of the shares of the shareholder company. One can argue that this cascading effect is inequitable from the perspective of the shareholders, and should as far as possible be eliminated from income tax systems.

109 Submission: Given the questionable theoretical basis for the provisions and the complexity that is associated with them, these provisions should be reconsidered.

110 Notwithstanding this, if it is decided to retain them, the following concerns should be considered.

Meaning of "effective interest"

111 A reduction in the effective interest of a company ('shareholder company') in the shares of a target company is central to the proposed amendment, both as a trigger event for the deemed disposal to occur (proposed s 22B(3A)(b) and paragraph 43A(3A)(b)) and also to determine the percentage of shares deemed to be disposed of.

112 Unlike the 2018 amendments to the debt relief rules in s 19 and paragraph 12A of the Eighth Schedule, which require taxpayers to consider the *market value of the effective interest* held by a person, the proposed anti-dividend stripping amendments do not define or otherwise specify the basis on which the effective interest must be determined.

Consider, for example, the situation in which there are multiple classes of shares in a company, all with different entitlements. How is one then to determine a percentage reduction in the "effective interest" in the shares in the company, if additional shares in any particular class are issued? The voting rights of existing issued shares may, for example, have decreased relative to the other shares, but the entitlement to dividends and returns of capital may remain the same, or *vice versa*.

113 As a result, the term is open for interpretation as either a change in the value of the effective interest that the shareholder company holds in the target company or merely a change in the percentage of the issued shares of the target company that the shareholder company holds, irrespective of whether a change in value has occurred.

114 In the absence of a clearly specified basis for determining whether a reduction in effective interest of a shareholder company has occurred or not, the proposed amendments may affect transactions that it was not intended to affect (i.e. share issue transactions at arm's length terms). Similarly, a lack of a clearly defined basis for determining the effective interest of a company may leave room for abusive schemes to escape the amendment on the basis of interpretation of the meaning of effective interest.

115 <u>Submission</u>: The basis to determine the effective interest of the shareholder company must be clearly specified in the amendments to s 22B and paragraph 43A of the Eighth Schedule.

116 Since an actual disposal of shares in the target company does not fall within the scope of the provisions where the disposal occurs in terms of the corporate restructuring rules in Part III of the Act, the same exclusion from scope should be extended to the deemed disposal that arises where shares are issued in terms of the corporate restructuring rules.

117 The current version of the proposal does not cater for this.

118 <u>Submission</u>: Subparagraph (2) of paragraph 43A should be amended to read:

119 "Subject to subparagraph (3), where a company holds shares in another company and disposes of any of those shares in terms of a transaction that is not a deferral transaction, or is treated in terms of subparagraph (3A) as having disposed of any of those shares <u>in terms of a transaction that is not a deferral transaction</u> and that company held a qualifying interest in that other company…".

120 Subsection (2) of section 22B should also be amended *mutatis mutandis*.

121 The new subparagraph (3A) is proposed to be added to paragraph 43A of the Eighth Schedule to the Income Tax Act. The proposed addition to subparagraph (2) provides that the "extraordinary dividend" attributable to the reduction in the effective interest shall be taken into account as a 'capital gain' in respect of the shares deemed to have been disposed.

122 The aforementioned tax treatment as a 'capital gain' is not consistent with the treatment as proceeds in the case of an actual disposal, and as such no parity exists between the two disposal types.

123 Furthermore, the inclusion of the words "*effective interest*", will encompass indirect shareholdings in addition to direct shareholdings.

124 Submission: The capital gains tax treatment in respect of actual disposals, and the treatment in respect of the proposed deemed disposal should be similar/consistent. This can be achieved by the treatment of the "extraordinary dividend" as proceeds, and allowing for a subtraction of an equivalent proportion of the aggregate base cost of the underlying shares against the proceeds.

125 It is proposed that the word "effective" be removed from paragraph (3A). This will ensure that only reductions in direct interests in the shares of the target company will be impacted.

Employment Tax Incentive (ETI)

Section 6(a)(ii) – ETI and SEZs

126 The purpose of the amendment to this section is to allow a company to claim the expanded Employment Tax Incentive ("ETI") (i.e. without any age limit), only if that company is a *qualifying company* as contemplated in section 12R of the Income Tax Act No. 58 of 1962. Section 12R defines a qualifying company for purposes of claiming the income tax incentives under the special economic zone ("SEZ") regime as discussed above from point 65. It has been proposed that the effective date of the amendment is 1 March 2019 – thus a retrospective change.

127 Section 6(a) (ii) of the ETI Act does not currently make reference to section 12R of the Act. If the proposed amendment to section 6(a)(ii) of the ETI Act is legislated, businesses involved in disqualified trades listed in section 12R of the Act or those listed by the Minister of Finance by notice in a Government Gazette will not be able to benefit from the ETI in respect of employees who are older than 29 years of age. Currently, the ETI tax incentive can only be claimed by an employer in respect of qualifying employees between the ages of 18 and 29 years of age.

128 Employer companies in certain industries have created new employment by employing qualifying employees in the SEZ. These employees were employed without having regard to the age limit. If the proposed amendment to section 6(a)(ii) of the ETI Act is legislated retrospectively, these employer companies will be financially impacted, as they will be seen to be carrying on a disqualified trade listed in the Government Gazette. Effectively, this means that they should not have claimed the ETI and the South African Revenue Service ("SARS") will be entitled to reverse the ETI utilised by these companies and charge penalties and interest in respect of the underpayment of employees' tax, Skills Development Levies and Unemployment Insurance Fund contributions.

129 Furthermore, the significant increase in the cost of employing the individuals may result in the jobs which were created, ultimately being lost. This contrasts with the intended purpose of the ETI legislation which was aimed at encouraging employment across specific sectors in South Africa, by reducing the cost to an employer of hiring employees from stipulated groups by way of a cost sharing mechanism with the Government, leaving the employees remuneration unaffected.

130 It is important to note that at the time that the ETI was introduced, the Explanatory Memorandum on the Draft Employment Tax Incentive Bill, 2013 stated the following:

131 "*Special economic zone: Special economic zones designated by the Minister of Trade and Industry pursuant to an Act of Parliament (currently the Special Economic Zones Bill, B3 of 2013), will be designated areas that promote targeted economic activities, supported through special arrangements and support systems including incentives, business support services, streamlined approval processes and infrastructure. The tax incentives for these zones will be authorised by the Minister of Finance, after consultation with the Minister of Trade and Industry."*

132 From the above, it is evident that it was recognised that the promotion of targeted economic activities was going to have to be supported through business support services. Individuals residing near a SEZ will benefit from the increase in employment opportunities within a SEZ. Whereas business operating in a SEZ will have their own employees, such business will still be reliant on other services (e.g. food and beverage service activities, security and investigation activities). There does not seem to be policy reason to exclude employees providing indirect services in a SEZ from the ETI, whilst advantaging employees providing direct services.

133 In the Explanatory Memorandum on the Taxation Laws Amendment Bill, 2013, reference was made not only to the manufacturing sector but also to business support services in the SEZs. At the time of introduction, the expanded tax incentives (i.e. the reduced income tax, value-added tax rates and accelerated special allowances) were used as a tool to encourage investment in the SEZ's, thereby growing and developing the economy in such regions which would hopefully lead to job creation.

134 Further to the above, in terms of section 4 of the Special Economic Zones Act No. 16 of 2014 (the "SEZ Act"), the SEZ is envisaged to be an economic development tool to promote national economic growth and export by using support measures in order to attract targeted foreign and domestic investments and technology. Amongst the identified purposes, specific mention is made to the following:

135 *"(h) creating decent work and other economic and social benefits in the region in which it is located, including the broadening of economic participation by promoting small, micro and medium enterprises and co-operatives, and promoting skills and technology transfer."*

136 In view of the above, at the time of implementing the extended ETI in the SEZs, the intention to exclude certain industries was not clear and accordingly, many employer companies set up businesses to provide support services to other companies in the SEZs.

137 The unemployment rate according to Stats SA, Quarterly Labour Force Survey, Quarter 2: 2019 increased from 27,2% to 29%. The extended incentive for employer companies operating within the SEZ, tackles a wider unemployment issue than just youth unemployment, which in turn has a positive effect on the growth of the economy and the increasing unemployment rate.

138 Submission: We request that National Treasure reconsider its intention to make the proposed amendment effective retrospectively. If the proposal is to be enacted, it should only be with effect from a future tax year. This would at least mitigate the negative financial impact on employers in the SEZ who claimed the ETI but no longer qualify, as penalties and interest will be payable to SARS in respect of the underpayment of employees' tax, Skills Development Levies and Unemployment Insurance Fund contributions.

139 In addition, we recommend that National Treasury obtains a list of all the jobs created in the SEZ, from 1 August 2018, per industry which will be disqualified as a result of the proposed amendment to the legislation and perform a cost/benefit analysis. National treasury should thereafter determine whether they should reconsider allowing these industries in the SEZ to benefit from the extended ETI in the SEZ.

INCOME TAX: INTERNATIONAL

Section 1 – Definition of 'Domestic Treasury Management Company' (Clause 2)

140 Clause 2(1)(c) deletes the word "and" after paragraph (b) of the definition of "domestic treasury management company" and inserts that word after paragraph (c). Clause 2(1)(f), however, deletes paragraph (c). The effective date of the clause 2(1)(f) is 1 January 2019 which is before the effective date of the change to clause 2(1)(c). Thus the effect of clause 2(1)(c) is to insert the word "and" after a paragraph that has been deleted.

141 Submission: The effective dates of the proposed changes should be amended to give effect to the proposals as set out in the Explanatory Memorandum.

142 It is unfortunate that foreign-incorporated companies which are tax resident in South Africa are being excluded from the definition of a 'Domestic Treasury Management Company' (DTMC) merely because FinSurv has not updated its circular. Foreign-incorporated companies, other than those that were registered with the SARB prior to 1 January 2019, will be denied the right to use a foreign currency as their functional currency.

143 A number of foreign banks would prefer to advance funds to an offshore company rather than to a South African company, or if they will advance to a South African company, they will do so on less favourable terms. A foreign company thus gets a better deal even though it is wholly-owned by a South African holding company. It seems unreasonable to deny the group this commercial saving.

144 Additionally, an effective date was not announced in the Budget speech, but in the TLAB the effective date is 1 January 2019. It is uncertain how a company that sought to bring itself within the 'Domestic Treasury Management Company' dispensation between the Budget speech and the release of the TLAB dates will be treated.

145 Submission: Clarity would be appreciated as to why the circular cannot be changed, as the effects of the proposed changes appear to go against the changes made in 2013 that were brought about to ease the burden for companies incorporated offshore but that have their place of effective management in South Africa. If the amendment is retained, we also suggest that the effective date thereof be brought forward to the date of promulgation of the Taxation Laws Amendment Act of 2019.

Section 9D – Reviewing the comparable tax exemption (Clause 10)

146 The reduction in the high-tax comparative rate from 75% to 67.5% of the South African corporate rate of 28% is welcomed. However, the fact that a reduction is required, highlights the fact that South Africa has become an outlier in respect of its high rate of corporate tax.

147 Submission: Although the reduction in the high-tax comparative rate is a step in the right direction, the results of the review are an indication that National Treasury should seriously consider a reduction in our corporate tax rate in order to stimulate investment and thereby reduce unemployment in the country.

Section 9D(9A)(ii) – Circumventing of the CFC anti-diversionary rules (Clause 10)

148 As currently worded, the provisions of this section will apply if there is *any direct or indirect benefit* to a connected resident in relation to the controlled foreign company. This provision is too broad and unclear.

149 Submission: For clarity, the provision should be amended to read: "is derived from any service performed by that controlled foreign company for the *contractual* benefit of a connected person…".

Section 31 – Reviewing the "associated enterprises" definition (Clause 36)

150 Although it is a term used in the OECD's Model Tax Convention, the inclusion of the term "associated enterprise" as an alternative to the term "connected person" in the definition of "affected transaction" introduces a great deal of uncertainty into the interpretation of section 31 (besides vastly widening the scope of the definition of "affected transaction").

151 The term “associated enterprises” is defined in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 2017. Accordingly, two enterprises are associated enterprises with respect to each other if one of the enterprise meets the conditions of Article 9, sub-paragraphs 1a) or 1b) of the OECD Model Tax Convention with respect to the other enterprise.

152 The OECD Model Tax Convention (MTC) (2017), states with regard to Article 9, sub-paragraphs 1a) and 1b) the following:

153 “*Where*

> *a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or*
>
> *b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, …”*

154 The term “associated enterprises” as defined above is very broad and requires further clarification. Furthermore, the OECD did not intend the term "associated enterprise" to be a defined term as recognised by SARS. It is a guideline for individual countries to consider in defining domestic related party provisions. SARS acknowledges this by referring to it as a term "contemplated" in the OECD Guidelines as opposed to "defined".

155 The definition contains three key tests, 1) participation in the management, 2) participation in the control or 3) participation in the capital of the other entity. In order for this to be determined, these tests need to be clearly defined. Control could mean a shareholding in another entity or voting power over that entity. The existing connected person test provides clear guidance on when such ownership or control results in the parties being connected. Adding this additional layer without any clear guidance creates unnecessary confusion.

156 Most OECD member and non-member countries apply specific rules including for example a percentage threshold to determine the level of shareholding required for the shareholder and the investment enterprise to be considered “associated”. For instance, many countries adopt a 50% threshold and some reduce this threshold to 25%1. India, which has recently adopted the associated enterprise definition into Section 92 of its Act, adopts a 26% threshold thereby providing certainty to companies on when they will be viewed as associated or not. Article 9 of the MTC provides neither a minimum nor a maximum limitation regarding direct or indirect participation in control. Moreover, as indicated above, the OECD states “it should be left to the contracting states [domestic law] to determine on the ‘broad basis’ of common understanding when participation in the

[1] Refer to country profiles listed on the OECD website

management, control, or capital of an enterprise may result [in a transfer pricing adjustment].[2]

157 Participation in management not only refers to voting rights but also the involvement in the management of the entity. The constitution of the Board of Directors could result in two companies being associated notwithstanding the fiduciary duty of the directors is to be independent in their appointment on a number of Boards. The question is then what proportion of common directors would create this association? If there is simply one common director would this trigger the association or should there be more than 50% common directors? Furthermore, certain countries may interpret the definition differently, especially around control and this could lead to double taxation.

158 Participation in capital also needs to be clearly defined. The advancement of a loan is arguably participation in the capital, as is being one of the key creditors of a company. A threshold needs to be considered as to the level of capital involvement that would meet the test for 'association'. In addition, clarity is needed as to whether the mere guaranteeing of a loan would be considered participation in capital.

159 Another key concern is whether a degree of economic dependency creates participation in either the capital or management of an entity. It is common under normal commercial operations for a company to outsource certain activities to a third party, for instance contract manufacturing arrangements whereby the contract manufacturer utilizes the intangibles of the company and manufactures solely for that company. It is therefore imperative to understand what levels of economic activity and dependency create an association.

160 Overall, the term "associated enterprises" creates the broad common understanding between two DTA States, but it requires domestic law clarification in order to be effective. Merely referring to the definition of "associated enterprises" as set out in Article 9 of the MTC would create undue uncertainty, unless further clarification is provided.

161 Submission: Tax policy should seek to make interpretation of the legislation clear to the ordinary person and provide for certainty. The current proposed amendment seems to achieve the opposite. The proposal will increase the complexity of our tax system, which is already extremely complex for a developing country and further increase the cost of doing business in South Africa for potential foreign investors.

162 We submit that in order to provide certainty to taxpayers the term "associated enterprise" should be defined with reference to clear parameters, for example, similar to the way the definition in other OECD member and non-member states is structured.

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2 Refer for example to Klaus Vogel on Double Taxation Conventions, 3rd Edition, Art. 9 para 23.

163 Alternatively, the term “affected transaction” could be defined to include any transaction, operation, scheme, agreement or understanding between an enterprise and its permanent establishment.

Section 31 of the Act – Reference to “associated enterprises” throughout the section (Clause 36)

164 Although the proposed insertion of “associated enterprise” is in the alternative to “connected persons” i.e. taxpayers transacting with connected persons or associated enterprises, the proposal does not seem to adapt the remainder of section 31 of the Act to align with this insertion. This means that following the definition of “affected transaction” in section 31(1) of the Income Tax Act, the remainder of the section is not updated to also align to insertion of the “associated enterprises” definition. That is, the remainder of the section only refers to the term “person”. However, the term “associated enterprises” as defined is much broader (refer to previous comment above) and also includes, for example, dealings between a legal entity and its permanent establishment. This may create inconsistencies when applying section 31 in the case of “associated enterprise”.

165 Submission: Section 31 of the Income Tax Act should be entirely updated to align with the term “associated enterprise”, if this concept is to be included in the definition of “affected transaction”.

ANNEXURE B

ADDITIONAL MATTERS

Section 10(1)(o)(ii) – Implementation Concerns

166 We understand that the prior year amendments to section 10(1)(o)(ii) of the ITA were effected on the basis that NT acknowledged that there were still concerns and practical challenges to address. To this extent, the effective date was deferred to 1 March 2020 and NT undertook to hold a workshop and consult on the remaining concerns.

167 The workshop was held and various concerns were raised. We note that, to date, no further clarification has been released on the legislative and practical problems surrounding this proposal.

168 Submission: We request that NT release, at minimum, an interpretation note on this section. A further workshop on this provision should also be scheduled as a matter of urgency to allow sufficient time for both industry and NT to explore appropriate solutions for the remaining concerns.

Section 12P and the Eleventh Schedule – List of exempt government grants

169 The list of grants exempt from income tax under the Eleventh Schedule currently includes government grants which have been terminated/suspended. Examples of these are, *inter alia*, the Enterprise Investment Programme and Manufacturing Competitiveness Enhancement Programme.

170 Additional grants, such as the Critical Infrastructure Programme and Aquaculture Development and Enhancement Programme, have been introduced by the Department of Trade and Industry, however, these are not reflected in the list of grants exempt from income tax under the Eleventh Schedule.

171 Submission: An update of the available government grants exempt from income tax should be provided in the Eleventh Schedule to reflect the grants which have been introduced and to delete those which have been terminated/suspended.