

Ref#608619

Submission File

31 March 2017

Davis Tax Committee
Hatfield Gardens (Block A)
333 Grosvenor Street
Hatfield, Pretoria, 0083

Per e-mail: taxcom@sars.gov.za

Dear Sir/Madam

SUBMISSION ON CORPORATE INCOME TAX

1. The South African Institute of Chartered Accountants (SAICA) welcomes the opportunity to make a submission to the Davis Tax Committee (the DTC) on Corporate income Tax (CIT) as there are many topics in this submission which are considered and debated by members of SAICA on a daily basis.
2. This submission includes a brief analysis on the following key aspects:
 - a. The need for simplicity and efficiency in the tax system;
 - b. Enhancement of the corporate rules;
 - c. Capital gains tax;
 - d. Anti-avoidance provisions;
 - e. Dividends Tax and Personal Income Tax rate increases;
 - f. Group taxation;
 - g. Dividend withholding tax (DWT) and the taxation of foreign dividends;
 - h. Effective tax rates;



- i. SA's tax administration landscape;
 - j. The "trade" test as a requirement for deductibility;
 - k. Source rules for services;
 - l. Source rule for digital services;
 - m. Interest-deduction regime;
 - n. Incentives; and
 - o. Proposed workshops and public consultation with NT/SARS.
3. As always, we have deliberately tried to keep the discussion of our submissions as concise as possible, which means that you might require further clarification. Please do not hesitate to contact us in this regard.

Yours sincerely

(Prof) Osman Mollagee

Chair: Tax Policy Committee

The South African Institute of Chartered Accountants



SUBMISSIONS

1. The need for simplicity and efficiency in the tax system

- 1.1. As a general matter, the determination of a company's taxable income is a matter of considerable complexity and complication. Tax practitioners and corporate taxpayers, almost without exception, consider that the SA income tax system in relation to companies requires substantial simplification.
- 1.2. The extent of the complexity in our tax law increases the cost of compliance (for taxpayers and for the South African Revenue Service (SARS)), the risk of errors and inadvertent non-compliance, interpretational disputes, the incidence of aggressive tax-avoidance schemes, and several other outcomes that detract from the efficiency of our tax system. There is substantial commentary (in academia, professions, policy forums, etc.) emphasising simplicity as one of the fundamental pillars of a good tax system.
- 1.3. The complexity in SA's Income Tax Act (the Act) is manifest in many of the individual provisions on a stand-alone basis and certainly also in the statute as a whole. The current Act has evolved over the last half-century (since its last consolidation in 1962) as a patchwork of specific provisions to address specific technicalities and transactional developments —with insufficient regard for overall policy and structure objectives or the desire to retain simplicity.
- 1.4. As to potential solutions, we concede that there is no “quick fix”. However, there are several considerations that we propose should be investigated (some more radical and far-reaching than others), such as:
 - restructuring and rewriting the Act in its entirety;
 - the relationship between general and specific anti-avoidance rules (also addressed separately in this submission);
 - reconsidering the extent of industry-specific provisions, which may in some cases be simplified or in other cases be withdrawn completely (either



because the general principles are in fact adequate or because the complexity simply results in large-scale misunderstanding, errors and non-compliance). In this respect, the question of whether the “tax-follows-accounting” concept can be adopted should be considered in certain areas. Many industry-specific matters are subject to stringent accounting rules, so it may be appropriate for our tax law to simply accept the accounting position in some scenarios (as has been relatively successfully done in the case of s24JB for banks). Some examples here might include the treatment of trading stock in general, although the specific regime for construction contracts (in s22(2A), s22(3A) and s24C) illustrates the issue more acutely, as well as the treatment of foreign exchanges differences in s24I, etc.

- The area of incentives suffers not only from potential lack of policy clarity (mentioned separately in another submission), but also from application complexity.

1.5. In what follows in our other submissions, you will also see that the issue of simplicity is a recurring theme.

1.6. Submission: We submit that the CIT regime should be simplified substantially, starting with the simplification of the Act. Ideally, the entire Act should be revised (with a clear simplification objective). However, we acknowledge that a piecemeal approach may be more easily achievable, e.g. considering a policy of “tax-follows-accounting” in select cases, the initiatives recommended in other parts of this paper, and so forth.

2. Enhancement of the corporate rules

2.1. The clear economic and commercial benefit of our corporate rules is that it allows taxpayers to undertake restructuring and streamlining initiatives-in scenarios where the ownership interests in underlying assets remains essentially the same-without being subject to the same tax complications that would have arisen if assets were being disposed of to third parties.



- 2.2. Whilst the corporate rules may be regarded as very 'rules-based', rather than being 'principles-based', SA taxpayers have all benefited from the certainty created by virtue of a 'rules based' regime.
- 2.3. In some instances, however, the rules are not considered wide enough, and we recommend that these should be investigated to determine whether the rules warrant extension.
- 2.4. One example is in relation to fund investments, since SA investors are not limited to only investing in local funds, where 'roll over relief' from CGT for investors is enjoyed when such funds are re-structured. However, this relief does not extend to SA investors who have invested in offshore funds, which are then re-structured.
- 2.5. Another example is the so-called "degrouching charge" in s45. Simply put, rolled over capital or revenue gains are triggered if the transferor and transferee companies cease to be part of the same group of companies within 6 years of the intra-group transaction.
 - The 6-year watershed period for a de-grouping charge is much longer than other trigger periods contained in the corporate rules. For example, in order not to be subjected to similar charges in terms of s42 asset for share transactions, a 'qualifying interest' as defined needs to be retained in the transferee company for a period of 18 months post the asset for share transaction.
 - The intra-group rule is the most restrictive of all, forcing, for example the group to keep the actual proceeds from the transaction in the group for a two-year period.
 - We acknowledge concerns around tax avoidance and, further, that a minimum "restraint" period is entirely appropriate as an anti-avoidance measure. However, we submit that the 6-year threshold has not kept pace with the increased dynamism in the world of corporate transactions. The spike in innovation and alliances, together with the harsher economic environment means that it is unreasonable to expect major groups to



remain static for extended periods. The fact that some other countries might also have used 6 years in the past does not constitute a helpful benchmark but rather (we submit) that those economies are also out of date.

- All corporate rules should have the same anti-avoidance rules to maximise application. Therefore, the degrouping watershed and the proceeds-retention period should be reduced to 18 months, in line with all the other corporate rules.

2.6. A further example is the problem around the s42 asset for share transaction, where the rollover base cost of the assets are also allocated to the shares in the target company effectively resulting in economic double taxation.

2.7. Submission: At the policy level, we submit that the group relief provisions should be retained and extended. At the more detailed level, some of the improvements we recommend include greater coverage of cross border scenarios where appropriate, and alignment of all the 'trigger' periods for the imposition of negative consequences on taxpayers who benefited from group relief, i.e. 18 months.

3. Capital gains tax (CGT)

3.1. CGT was introduced in SA over 15 years ago, representing a fundamental policy shift. Whilst there are many arguments for and against this policy-shift, one critical (negative) aspect was the dilution of the distinction between capital and revenue. Economically this means that entrepreneurs are less-encouraged to realise the capital growth of their enterprises. (For example, selling one business in order to start or acquire a new business stopped being "tax neutral").

3.2. The CGT regime which was adopted was relatively simple to implement, as it was premised on the building blocks of defined terms such as "proceeds", "base cost" and "asset". The CGT rate was intended to be relatively low, not only in order to compensate for the effects of inflation on the computations of capital gains, but also limiting the negative impact referred to above (i.e. restricting



change-of-investment decisions). In order to achieve this, a fractional inclusion rate was applied to the net capital gains for a year, which was then taxed at the statutory tax rate, resulting in a relatively low amount of CGT being payable. The effects of inflation on an asset's base cost over time were not otherwise adjusted for in the CGT regime as a result of the application of the fractional inclusion rate.

- 3.3. However, given how the inclusion rates for CGT have increased over the last few years, we believe it is time to review SA's CGT regime. The combined result of the absence of an appropriate mechanism to exclude the impact of inflation on the increase in an asset's value over time and ever increasing inclusion rates is that taxpayers are unfairly taxed on capital gains. This was not the intention of the legislature when CGT was introduced in 2001. In summary, the focus on CGT as a revenue-raiser has made us lose sight of the original policy objectives. The high CGT rate is a contributing factor to the current situation where capital is more "trapped".

- 3.4. Submission: At the policy level, we recommend that the CGT regime be entirely reconsidered in principle. As an alternative, we submit that the effective CGT burden should be reduced, not increased. For example, we recommend that the CGT inclusion rates be reduced or alternatively that an inflation indexation system be introduced in order to tax only real capital gains.

4. Anti-avoidance provisions

- 4.1. With the objective of addressing perceived tax avoidance, SA's corporate tax regime has in recent years seen a proliferation of narrow specific anti-avoidance rules, rather than the application of general anti-avoidance principles. This exacerbates the problem of complexity discussed earlier. We submit that continuing upon this path will (and, to some degree, already has) render anti-avoidance initiatives uneconomic, i.e. when comparing the marginal revenue collection to the burden and complexity of policing them.
- 4.2. In our view, we should limit (substantially) our reliance on specific anti-avoidance rules and focus instead on a combination of:



- (a) placing greater reliance on the general anti-avoidance rule (GAAR) in the Act together with the detection capabilities of SARS during audits; and
 - (b) reducing the incidence of tax avoidance schemes through a lower tax rate and improved tax morality.
- 4.3. Although we concede that specific anti-avoidance rules may be necessary in some cases, their use should be limited to exceptional situations and should endeavour to observe the objective of simplicity.
- 4.4. For example, there are complex sections that have been introduced, based on base erosion and profit shifting (BEPS) initiatives, such as the hybrid debt and equity instruments, in ss8E, 8EA, 8F and 8FA. These 'hybrid' instruments rules were matters of policy, i.e. where an instrument exhibits more debt qualities than equity (e.g. *secured* preference share funding), it should be taxed as though it is debt, and *vice versa* (e.g. debt issued with no repayment date looks more like equity). NT then carved out some exceptions to those rules, which are also really complex and were based on specific transactions which they felt (on request from industry) should not be re-characterised. These provisions are often called sections of specific anti-avoidance, but they also enable a broad policy decision with regard to re-characterisation where base erosion may otherwise occur. The use of the GAAR in these instances would not achieve the same objective.
- 4.5. Another example of very complex legislation which was enacted as a result of policy objective to prevent base erosion is s9D. It was a policy decision to include all passive type SA controlled offshore vehicles into the SA tax net, and utilising the GAAR would not have achieved that objective. Once again, in implementing this policy and allowing exceptions, the legislation became overly complex, which makes application challenging as it requires taxpayers to apply exclusions and exemptions which differ between income types.



- 4.6. Submission: We submit that specific anti-avoidance rules should be reviewed and reconsidered. We propose that SA should, instead, adopt a more comprehensive, but simpler, approach to addressing tax avoidance, including reducing tax rates and relying more on general anti-avoidance principles.
- 4.7. We also recommend that the DTC should consider the chapter on SA as it appears in the publication of West, C. & Roeleveld, J. *“Tax Avoidance Revisited: Exploring the Boundaries of Anti-Avoidance Rules in the EU BEPS Context”* (In A.P. Dourado (ed.) EATLP International Tax Series Vol 15) (publication forthcoming). We will make a copy of this chapter available to you once it has been published. The book itself, which covers the experience of many countries, will provide useful research on this area.

5. Dividends Tax and Personal Income Tax rate increases

- 5.1. Having experienced five years of dividends tax, we are of the view that the system is far simpler and better than the secondary tax on companies' regime.
- 5.2. However in our view the recent increase in the rate of dividends tax from 15% to 20% is regrettable.
- 5.3. The rate of dividends tax cannot be considered in isolation. It was clear from the 2017 National Budget (the 2017 Budget) that the increase in the rate of dividends tax was largely motivated by the increase in the top income tax rate for individuals from 41% to 45% and the perceived need to reduce opportunities for arbitrage. Following this reasoning, in considering whether the increase in the rate of dividends tax of 20% is desirable, one therefore has to critically examine the decision to raise the top rate for individuals to 45%.
- 5.4. In our view the increase in the top rate of income tax for individuals is likely, over the longer term, to lead to flight of talent, loss of foreign direct investment and long term reduction in tax revenue. The relatively low additional revenue anticipated from this measure (R4.4 billion for 2017/2018) may be negated by the negative economic effects over the longer term.



5.5. The combined rate of CIT and dividends tax in the absence of double taxation agreement relief has increased from 38.8% to 42.4% as a result of the increase in the dividends tax rate. It is our view that our tax policy should assist in fostering economic growth and attracting foreign investment. The increase in the top rate of income tax for individuals and the dividends tax rates achieve neither.

5.6. Submission: We submit that further research should be undertaken to assess the impact of the higher dividends tax and personal income tax rate on talent and resource flight.

6. Group taxation

6.1. As a general matter, SAICA stands by its previous calls for the implementation of a broader group taxation regime for SA. SAICA submitted a proposal in this regard in 2010 (A copy is attached herewith).

6.2. However, concerns remain around potential complexity, i.e. whether the chosen mechanism for group taxation will enhance, or detract from, our earlier submission for a move to greater simplicity.

6.3. In this respect we note that loss-surrender regimes (such as the UK) represent a potentially workable example for SA to consider. However, it is clear that further research will be required.

6.4. A further issue to take into account on the question of introducing group taxation is the fact that many companies cannot divisionalise due to commercial or regulatory reasons and as a result losses are clogged. It is important for purposes of levelling the playing field that such corporates are not hampered by these commercial and regulatory considerations and losses should therefore be allowed to be shared in these circumstances, for example where the group companies are 100% held.

6.5. Submission: We submit that a group taxation regime should be considered and implemented for SA. In this respect, a loss-sharing regime should ideally be introduced, as recommended by SAICA, as a first step towards group taxation.



- 6.6. We further submit that other examples should be considered such as the US, Netherlands and Australia group tax regimes, but in light of our overall objective of simplicity, the UK example of loss-sharing may be more appropriate for SA.
- 6.7. Critically however we stress that the introduction of a group tax system must be motivated by implications for the economy including stimulating economic growth, simplicity, tax administration and compliance (for taxpayers and for the SARS), rather than with reference to the potential for a one-off adverse impact to revenue collections. Relatively simple transitional rules can address concerns in this respect.

7. Dividend withholding tax (DWT) and the taxation of foreign dividends

- 7.1. The recent increase in the dividend withholding tax rate from 15% to 20% (which has edged much closer to the corporate income tax rate of 28%) has called into question the policy of fully taxing foreign dividends in circumstances where the participation exemption in s10B does not apply. The current policy is to tax such dividends at the DWT rate as income, but no deductions are allowed in respect thereof in terms of s23(1)(q). We do not believe that this outcome is correct if the income received is actually being taxed.

- 7.2. Submission: We submit that it is time to re-evaluate the policy applying to the taxation of foreign dividends, where such dividends are taxable in SA.

8. Effective tax rates

- 8.1. A review of various industries' effective tax rates may provide an overview of the relative sources of SA's CIT contribution. However, this analysis should also reveal how quickly corporates respond to declining economic conditions in terms of decreased income, increased losses and a resultant decline in CIT, in other words the tax buoyancy must be considered as a matter of policy.
- 8.2. We believe that the optimal corporate income tax rate for SA should be reconsidered. The Minister acknowledged in the 2017 Budget that the current rate of 28% is relatively high by global standards, and more particularly by sub-Saharan standards. The relative severity of this rate acts as a major



disincentive for foreign investment and therefore results in a decline in CIT revenue over the long term. Relatively high rates of CIT only result in short term increases in tax revenues.

- 8.3. We consider that a decrease in the CIT rate presents itself as a powerful option to encourage foreign direct investment and stimulate corporate SA into reinvesting into its own infrastructure, thereby leading to long term increases in tax revenue and a decreased reliance on foreign debt.
- 8.4. A holistic approach is however required having due regard to the overall structure of the tax system, including the role or appropriateness of incentives to stimulate economic growth (see discussion below).

8.5. Submission: We submit that the CIT rate in SA should be reviewed in the context of stimulating growth, comparability with corporate tax rates globally, the objective of simplicity and reducing tax avoidance (in terms of BEPS as well as generally).

9. SA's tax administration landscape

- 9.1. A discussion of the optimal CIT system is incomplete without consideration of the effectiveness of SARS in the administration and collection of CIT. A vital part of an effective tax administration is for CIT laws to be interpreted consistently and applied fairly across different taxpayers, as this affords taxpayers confidence in the CIT system and the certainty they need in order to budget for their annual CIT costs.
- 9.2. We understand that the DTC has a tax administration sub-committee and its role in evaluating the performance of SARS was referred to by the Minister in the 2017 Budget. However, we note that there have not been any calls for comment from the DTC to taxpayers in relation to tax administration.

9.3. Submission: We recommend that the DTC engage with the different spheres of commerce and industry in order to assess SARS' perceived levels of fairness and efficiency. SAICA has already expressed its willingness to engage in this process.



9.4. We submit that the tax administration system must undergo further reform as part of a holistic review of the CIT system to ensure ease of administration, simplicity and accessibility to all taxpayers as well as ensuring observance of the constitutional values of reasonability, rationality, and procedural fairness.

10. Scrapping of the 'trade' test as a requirement for deductibility of expenditure in addition to the 'in the production of income' test

10.1. The trade test for deductibility of expenditure is contained *inter alia* both in the preamble to s11(a) as well as s23(g). It is also found in other provisions, such as s24J.

10.2. The trade requirement creates unnecessary complexity and uncertainty in a commercial context. A considerable body of case law has developed on questions relating to the trade requirement as to whether or not a taxpayer was trading when expenditure and losses were incurred.

10.3. In our view it is unnecessary to have the two separate tests. Provided that expenditure is incurred in the production of a taxpayer's income, such expenditure should be deductible without a further requirement that the taxpayer be conducting a trade. A taxpayer is taxed on income whether or not such income is derived from a trade. Therefore expenditure should be deductible whether or not it is derived from a trade, provided it was not of a capital nature and incurred in order to produce the income.

10.4. Although s11A has alleviated the income tax consequences in which pre-trade expenditure is incurred, the issue often creates problems in the incurrence of expenditure by group holding companies as well as the deductibility of expenditure incurred in the production of passive income such as interest and taxable dividends.

10.5. For companies, the problem is exacerbated by the unfairness in s20, effectively forfeiting the assessed losses of companies that do not trade for a full tax year.

10.6. Submission: We recommend that the trade requirement be scrapped in its entirety.



11. Source rule for services rendered in the context of digital services (including e-commerce transactions)

- 11.1. The application of our source rules in a digital environment requires a critical reconsideration. Further research is required to ensure that the law keeps up with the fast pace of development of the digital economy.
- 11.2. The source rules in s9 do not address services *per se*, and certainly not services rendered in the context of e-commerce transactions. The vast majority of our jurisprudence in relation to services rendered comes from the pre-electronic commerce era.
- 11.3. Services related to digital transactions pose a number of problems, often in that the role of the location of a server in determining the source of the income from services is unclear.
- 11.4. For example, if a SA-resident renders the services, it is unclear whether the taxpayer may claim a rebate in terms of s6quat(1A) or merely a deduction in terms of s6quat(1C) for foreign taxes incurred. Further issues arise in this area in relation to non-residents that render services to residents.

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| <ul style="list-style-type: none">11.5. <u>Submission</u>: We therefore recommend that a source rule for services be developed. We suggest a general rule for services rendered as well, possibly, as a specific rule catering for digital services (if the latter cannot be incorporated into the general rule).11.6. We also recommend that the DTC refers to the research paper "<i>The source of income from the sale of goods electronically: an analysis of the division of the taxing rights in cross-border situations</i>" by Zafar Harnekar, which we consider deals with the issues in point. (A copy is attached herewith). |
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12. Deduction for interest and similar finance charges

- 12.1. We note that there is considerable uncertainty around the deductibility of interest expenditure from a CIT structural perspective. Definitional debates as well as anti-avoidance approaches in relation to interest remain unresolved.
- 12.2. By way of example, although s24J caters for the deduction of 'similar finance charges' in the context of instruments, in other contexts other finance charges as opposed to interest, may not be deductible if the finance charges are considered to be of a capital nature.
- 12.3. Even in a s24J context, problems may arise in deducting 'similar finance charges' if the finance charges accrue to a party other than the holder of the instrument. We are of the view that finance charges that relate to debts in respect of which interest is deductible should also be deductible as a matter of policy and that a specific provision be inserted in this regard. In reality such finance charges represent a cost of borrowing similar to interest.
- 12.4. The meaning of interest in the context of SA's withholding tax rules also remains subject to debate.
- 12.5. Furthermore, in response to the perception of interest as a tax-avoidance tool, there are numerous specific anti-avoidance provisions (such as s8F, s23K, s23M and s23N), that make it hard for corporate financiers and borrowers to comprehensively consider the implications of interest-bearing debt.

<p>12.6. <u>Submission:</u> We further submit that the deductibility of interest must as a matter of policy be revisited from a holistic tax structural perspective. Matters such as intended ambit and definitions as well as anti-avoidance provisions should be prioritised.</p>

13. Incentives

- 13.1. The role and effectiveness of tax incentives remain hotly debated topics. In our view, certain incentives are potentially very effective.



- 13.2. However, we are concerned that matters of administration and complexity contribute, in many cases, to defeating the policy objectives of certain incentives.
- 13.3. For example, we are of the view that the incentive in s11D does not currently achieve its aim of encouraging and promoting Research & Development (R&D) in SA:
- The uncertainty regarding whether a company will qualify for the incentive, as a result of the nature of the Department of Science and Technology (DST) pre-approval process (including the lack of transparency in the decision-making process) is a significant drawback.
 - As a result of the excessive time it currently takes for an application to be finalised by DS&T (the 2016 tax amendments even makes provision for assessments to be re-opened beyond the prescription period of three years in an attempt to cater for the undue delays) companies cannot adequately plan and budget for R&D.
 - Furthermore, the impact of the deduction-prohibition in s23I also contradicts our policy objective of encouraging R&D in SA.
- 13.4. Several other examples exist in relation to incentives for energy renewal and so forth.
- 13.5. Returning also to the earlier submission on simplicity, it may also be appropriate to address the very concept of incentive separately, with the aim to not only deal with incentives holistically, but also to ensure simplicity as well as efficacy.
- 13.6. Submission: Further research is required to ensure that incentives are properly aligned with the policy goal they are intended to achieve, that they keep pace with the changing environment and need for investment, and that the appropriate industries are targeted.



13.7. For example this allows for an ideal opportunity for stimulating renewable energy projects such as wind farms, desalination and hydro-electric plants, all which will create employment. China has been very successful in this area.

14. **Proposed workshops and public consultation with NT/SARS**

14.1. The workshops are considered to have significant shortcomings, the first being that there is no express statement of policy, for example, no white paper on bills and no expression of the policy intent. The exception was the retirement reform process. Tax Policy direction is required in terms of a tax statement on corporate and all other taxes. This is aimed at being an opening stance in other words confirmation of what policy it is that needs to be addressed. An example is the policy direction for tax avoidance from a holistic perspective.

14.2. The time frames for providing public comment and making submission to SARS and NT are relatively short which means that the consultation process is not considered to be efficient. Whilst this is not unique to SARS and NT, it is considered that taxpayer rights are routinely being materially and adversely affected by legislative changes and that proper prior consultation is imperative.

14.3. Submission: We submit that a coherent approach is required and that there is a dire need for a tax policy framework. By having a clear and express policy statement apart from stating in broad terms that it ties in with the National Development Plan (NDP) or revenue collection, gives direction to stakeholders of what is being debated and what the ambit is of what needs to be achieved and how to translate this into NT actions.

14.4. We further submit that specific attention must be given to the public consultation process to ensure more efficient time frames for taxpayers and tax practitioners participating in a more meaningful public consultation process.