South African Institute of Tax Professionals

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The South African Revenue Service
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RE: COMMENTS CONCERNING THE DRAFT TAXATION LAWS AMENDMENT BILL (TLAB), 2015: PERSONAL INCOME TAX ISSUES

Attached are the SAIT personal income tax comments associated with the draft Taxation Laws Amendment Bill. We believe that constructive private sector participation is valuable, and we expect that a workshop is probably pending on these issues in early September. The comments provided only cover issues of concern.

Should you have any further questions, please do not hesitate to contact me.

Yours sincerely,

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Vice-Chair of the Personal Tax Committee

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I. NON-DEDUCTIBLE RETIREMENT FUND CONTRIBUTIONS AND AVOIDANCE OF ESTATE DUTY (PROPOSED SECTION 3(2)(bA) OF THE ESTATE DUTY)

1. TLAB draft proposal

The Bill proposes to bring non-deductible contributions to retirement funds (i.e. provident, pension fund and retirement annuities) into the "dutiable estate" for Estate Duty purposes. The purpose of the amendment is to limit certain schemes that artificially eliminate the tax base of the Estate Duty. In these schemes, an elderly person (or a person nearing death) can make a large one-off contribution to a retirement fund solely to avoid Estate Duty. The savings growth in the fund stemming from these contributions is likely to be small because the contributed amounts are fully withdrawn by heirs shortly after death.

2. Concern

We fully agree that this scheme needs to be closed if one believes that the Estate Duty should be a viable form of revenue. Large scale one-off contributions as outlined above can effectively eviscerate the Estate Duty base with little effort. At issue for us are the more middle-income clients making excess contributions to retirement funds. Many of these clients in the upper-middle income range make regular recurring excess contributions to retirement funds with the Estate Duty operating as an incentive to promote long-term savings. These regular recurring contributions can span several years. This group viewed savings as inter-generational and something more than a tax avoidance scheme.

3. Possible suggestion

Recurring savers should not be punished by the recent attempt to close loopholes, especially since retirement fund amounts cannot be automatically withdrawn given the non-tax regulatory restrictions associated with these funds. Therefore, we suggest that the newly proposed anti-avoidance provision be limited to death-bed contributions. Under this narrower version of the test, it is proposed the new rule should apply to contributions occurring solely upon reaching a certain age (e.g. 55 or 65) and / or three years before death so that lump sum avoidance contributions are eliminated.

We also believe that the effective date of the amendment should be adjusted so that the anti-avoidance rule applies only to "contributions" made on or after 1 January 2016 given the fact that many non-deductible contributions were small recurring amounts. In the very least, the proposed effective date based on death should apply only to the avoidance lump sum contributions outlined above.

II. TRUST VESTING OF SECTION 8C INSTRUMENTS (PROPOSED PARAGRAPHS 13(1)(iiB) AND 80(1) OF THE EIGHTH SCHEDULE)

1. TLAB draft proposal

The proposed amendment deals with the timing of the gain from a tax perspective should a trust vest equity instruments in the hands of a beneficiary that is an employee. However it does not state that there is no double tax liability in the hands of the employee in such event to the extent that the base cost to the trust is less than the market value upon vesting. In other words, there always appears to be liability in terms of section 8C over and above whatever liability may arise in terms of the timing of the vesting from the trust's perspective. The disposal rules in section 8C appear to remain unchanged.

2. Background

Most large companies rely on discretionary employment trusts as the preferred format for administering employment equity schemes on behalf of employees and BEE participants (whereas, vesting trusts are mainly used for smaller management schemes). As National Treasury and SARS are well aware, there has long been a problem of potential double taxation in the case of section 8C instruments and discretionary employment trusts. National Treasury and SARS are also aware of certain employee trust schemes can trigger capital gain in lieu of ordinary revenue even though the underlying gain should be ordinary under section 8C. Section 8C instruments should result in a single level of ordinary revenue until the restrictions have been lifted because section 8C gain effectively represents a disguised form of employment revenue.

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The exact language used by the amendment to paragraph 80(1) appears confused. Who is the "person acquiring the section 8C equity instrument"? Is this intended to impact all equity instrument or just those equity instruments that are indirectly connected to employee restricted trusts? Upon review of the legislation, it appears that the capital gain charge for vesting section 8C instruments has been shifted from the beneficiary level to the trust level (paragraph 80(1) of the 8th Schedule). On the other hand, the words only exclude the gain from paragraph 80(1)? If one falls outside paragraph 80(1), where does the gain sit or does the gain effectively sit nowhere?

Example 1 (basic vesting): Employee Trust purchases thousands of Employer shares for R1 000 upon formation for all employees and vests 200 of the shares five years later in the hands of certain beneficiary employees. The shares are worth R5 000 per share at the time of the vesting.

Pre-2015 Amendment Outcome: Before the amendment, the R4 000 of capital gain per share vested in the hands of the beneficiary. If restrictions were removed at the time, section 8C also applied. However, section 8C gain was effectively eliminated from the 8th Schedule because proceeds do not include gross income amounts under paragraph 35.

Proposed Outcome: As a result of the amendment, the R4 000 gain is arguably taxable in the hands of the trust (depending on the interpretation – others could argue the gain is gone complete). If the gain is in the trust, this gain should arguably result in an elevated base cost (see paragraph 20(1)(h)(i)). Is this the result intended?

Example 2 (sale before vesting avoidance / currently outside the scope of the Bill): Employee Trust purchases thousands of Employer shares for R1 000 upon formation and seeks to hand over equivalent cash value in respect of 200 of the shares five years later in the hands of certain beneficiary employees. The shares are worth R5 000 per share at the time.

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Outcome before and after the amendment: Because the Employee Trusts disposes of the shares before vesting, paragraph 80(1) does not apply. It is argued that paragraph 80(2) also does not apply because the beneficiaries are said not to have any vested interest in the gain or the asset (they presumably have a right only to equivalent growth). If both paragraphs do not apply, some argue that the gain is wholly outside the system (a result clearly undesirable from a National Treasury / SARS point of view). The employees receive the cash tax-free and the subsequent surrender of trust units is a non-event (no cost price exists in the units and no proceeds are surrendered in exchange).

3. <u>Draft suggestion</u>

We would first suggest that the explanatory memorandum provide a detailed numerical example of how these rules interact to clarify the situation, especially given the complexity and confusion in this area. We had hoped that the law would be clarified to ensure a single level of ordinary revenue in respect of section 8C instruments. Capital gain treatment would mean that section 8C is avoided. A dual charge has no justification. This seems not to be the case if our interpretation is correct.

In terms of potential drafting, we think the problem lies in section 8C. Section 8C instruments should solely be taxed under section 8C until out of that regime (and be excluded from the Eighth Schedule in the meantime (probably by way of exemption). These instruments should instead fully give rise to ordinary revenue until the restrictions are lifted. Paragraph 80 also needs to be fixed for situations falling outside of paragraphs 80(1) and 80(2). Gain must lie somewhere unless specifically exempt.

Side note: Proposed paragraph 13(1)(iiB) states that the timing of the capital gains event for vesting is based on the "granting" by the trust. This language, however, is confusing because the trust does not "grant" the section 8C instrument. The date should either be the date of vest or the date of "acquisition" referred to in the amendment of paragraph 80(1)).