sait South African Institute of Tax Professionals

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Dear Ms Mputa and Mr Swart

RE: URGENT TECHNICAL CORRECTION ARISING FROM THE 2014 TAXATION LAWS AMENDMENT ACT // SECTION 31 TRANSFER PRICING DEEMED DIVIDEND

One of the missions of the South African Institute of Tax Professionals ("SAIT") is to protect the public interest by participating in policy formation and implementation. To this end, SAIT made detailed submissions for consideration in Annexure C of the 2015 Budget Review.

Members of the Institute, however, brought it under our attention that an unintentional anomaly arose by the amendments to section 31 of the Income Tax Act (No. 58 of 1962) ("ITA") that was somehow not included in the our Annexure C submission, hence the urgency of this submission.

Our members support the 2014 transfer pricing amendment that eliminates deemed loan treatment for correlative adjustments in favour of deemed dividends/donations.

The transfer pricing experts within our constituency also support the overall transition process, which converts existing deemed loans into deemed dividends. It is common cause that the conversion process began effective 1 January 2015.

At issue are technical conflicts within the precise date and the practicality of the actual due dates for payment. Set out below are the full details of the concerns raised and a request to remedy these concerns either through revised legislation and/or SARS guidance.

1 APPLICABLE LAW

1.1 2011 Amendment: Deemed Loan Correlative Adjustment

Section 31 of the ITA was amended by section 57 of the Taxation Laws Amendment Act (No. 24 of 2011) ("2011 TLAA") for years of assessment beginning on or after 1 April 2012.

The 2011 TLAA introduced a new regime for transfer pricing adjustments. Section 31(2) specifically requires that the taxable income or tax payable in respect of the person receiving the tax benefit must be calculated as if the transaction were at arms-length.

If this recalculation of taxable income or tax payable results in a difference, the revised version of section 31(2) treats the arms-length pricing adjustment as a deemed loan that is an "affected transaction" (section 31(3) prior to its repeal by the Taxation Laws Amendment Act (No. 43 of 2014) ("2014 TLAA"). Section 31(3)(a) requires a hypothetical question to be answered. If the transfer pricing adjustment between the application of section 31 and the underlying transaction results in a differential, this hypothetical differential gives rise to a deemed loan. The net effect of this deemed loan is to trigger annual interest (which in turn is taxable as ordinary revenue) until the deemed loan is repaid.

1.2 2014 Amendment: Deemed Dividend Donations Correlative Adjustment

The deemed loan regime has since been repealed by the 2014 TLAA. Under the 2014 TLAA, the deemed loan concept will terminate. Correlative adjustments will instead be viewed as deemed dividends/donations as from 1 January 2015.

In terms of this new deemed dividend concept, section 31(2) further provides that deemed dividend arising from new correlative adjustments arising from 1 January 2015 will be treated as a dividend *in specie* declared six months after year-end. It should be noted that a dividend *in specie* is an actual primary liability for the payer as opposed to a cash dividend (only creating a withholding liability for the payer).

The 2014 TLAA also introduces a special transitional rule that effectively converts all pre-existing section 31 deemed loans into deemed dividends/donations. These deemed dividends are again viewed as dividends *in specie.*

This conversion from pre-existing deemed loans to deemed dividends is deemed to occur at 1 January 2015. Unlike deemed dividends arising from new correlative adjustments, this transitional dividend does not have an explicit 6 month rule. This deemed dividend instead falls under the general Dividends Tax date for payment (section 64K), which is the close of the month following the month of the dividend (i.e. approximately two months).

2 TECHNICAL CONCERNS

2.1 Practical Timing of Payment

The first issue relates to the timing of the Dividends Tax payment in terms of practical compliance. This problem arises due to the lack of co-ordination between the date when the deemed dividend will be calculated by the tax practitioner/company compliance team under the normal tax versus the date of SARS payment under the Dividends Tax.

The differential between the actual "taxable income"/"tax payable" versus the hypothetical section 31 determination of "taxable income"/"tax payable" is a taxable year-end concept under the normal tax. This differential can technically arise only at year-end (i.e. when the differential is "applied in the calculation of taxable income"). The normal tax return associated with this differential is only due 12 months following the taxable year-end (when the company tax return for the prior taxable year is due). As a practical matter, compliance tax specialists will only make the calculation in the following 12-month period during which the normal tax return is due.

On the other hand, the Dividends Tax payable under this new rule arises much earlier, thereby creating a trap for the unwary.

As stated above, deemed dividends arising from new (2015+) correlative adjustments are due 6 months after the tainted section 31 transaction. This date precedes the year-end normal tax calculation.

The problem is further aggravated in the case of 1 January 2015 transitional deemed dividends. The Dividends Tax arising from the pre-existing 2014 deemed loans are due only two months later (as of the close of February 2015).

Example 1 (Transition Year)

Company X has a taxable year-end of December 2014 (a calendar year taxpayer). For purposes of this example, the section 31 tainted transaction occurred on 1 August 2014. This transaction initially falls under the deemed loan rule, which is theoretically calculated only as from 31 December 2014.

Under the new transitional rule, the deemed loan is converted into a deemed dividend as from 1 January 2015. The technical calculation in respect of this deeming provision can only be prepared starting from the end of 2015. Moreover, the normal tax return is due 12 months later (as of the close of 2016) with returns rarely being submitted prior to this date because these returns are dependent on the financials being finalised.

As a technical matter, however, the Dividends Tax for the transitional deemed dividend is due as of the close of February 2015 (the month following the month of January 2015). This date is wholly impractical.

Example 2 (Post 2015 Years)

Company Y has a taxable year-end of February 2016 (a calendar year taxpayer). The transaction subject to a section 31 adjustment occurs within the same taxable year (on 10 October 2015). The section 31 correlative adjustment is technically tied to the 2016 year's taxable income calculation. As a practical matter, this difference is typically only quantified by the relevant compliance officer in the last three months before the close of February 2016 (i.e. when the financial accounting statements are finalised).

However, as the law stands, Company Y must now pay Dividends Tax as of 31 August 2016 in respect of the section 31 differential that is deemed to arise at the close of 31 August 2016. However, this payment date precedes the due date of the tax return associated with the 2016 tax return. The compliance officer will most likely miss the payment date for the Dividends Tax because the officer's annual normal tax calculations will not be fully complete until six months later (when the normal tax return is due). Even if the compliance offer is prepared well in advance, Company Y can at best only estimate the Dividends Tax liability during the 6 months prescribed and subsequently make corrections for any deviations from estimate when the return for the normal tax is formally due.

2.2 Technical Omission

Section 31 of the ITA does not state when the difference originates in terms of the previous deemed loan regime.

The only guidance in the provision is the reference of section 31(2) to "in calculating the taxable income or tax payable" and section 31(3)(a) refers to "applied in the taxable income", which refers factually to the timing of the taxable income calculation. From the above, it is clear that there must be some form of taxable income determination, which practically can only be performed on submission of the return (the formal date when tax positions are taken).

Without a specific timing provision, it is technically unclear whether the "difference" arises on date of transaction, tax year-end or actual determination of the taxable income by the taxpayer in the return? This date is imperative in determining whether a deemed loan existed before 1 January 2015.

3 PROPOSALS

The due date for paying the Dividends Tax arising from the section 31 correlative adjustment should be better co-ordinated with the normal tax associated with the same taxable year to prevent unintended compliance traps for the unwary. More specifically,

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Deemed dividends arising from post-2014 transactions should trigger Dividends Tax payments within 12 months after the taxable year-end so that the Dividends Tax payment is fully co-ordinated with the due date of the normal tax return arising due the same period.

Transitional 1 January 2015 dividends arising from the conversion of 2014 deemed loans should receive a similar 12-month payment period. The current 2 month period is technically impossible because the section 31 taxable income calculation technically arises only after the 2 month period (and the 2 month period is also wholly impractical).

Kindly note that a similar problem previously existed in respect of mineral royalties. Under the initial version of section 6 of the Mineral and Petroleum Resources Royalty (Administration) Act (No. 29 of 2008), the royalty return had to be submitted 6 months after year-end even though the normal tax return was due 12 months after year-end, giving rise to inevitable differences. This practical problem was corrected by section 28 of the Tax Administration Laws Amendment Act (No. 39 of 2013) with the revised rule aligned to the 12-month return due date.

In terms of the second issue, the time in which pre-2015 correlative adjustments (i.e. deemed loans) should be clarified so that the deemed loan is deemed to arise when the tainted (i.e. affected") transaction arises.

4 CONCLUSION

We thank you for your attention on this technical compliance issue and will make ourselves available should you wish to discuss this matter further.

Yours sincerely,

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