8 August 2016

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Comments on draft Bills

We refer to the invitation by The National Treasury and SARS for written comments on the 2016 Draft Taxation Laws Amendment Bill (TLAB) and the 2016 Tax Administration Laws Amendment Bill (TALAB).

Please find the comments from SAIT's personal income tax committee. The comments are presented in the order the clauses appear in the respective Daft Bills and we start with the draft Tax Administration Laws Amendment Bill first.

COMMENTS ON THE DRAFT TAX ADMINISTRATION LAWS AMENDMENT BILL, 2016.

Clause 5: insertion of a new paragraph (d) into the definition of "provisional taxpayer" (in paragraph 1 of the Fourth Schedule to the Income Tax Act)

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Proposed amendment

Under this proposal the Commissioner will be given the power to, by public notice, notify any category of persons that they are provisional taxpayers.

Form the draft Explanatory Memorandum it is clear that the primary aim of the amendment is to allow the Commissioner to request local employees to pay provisional tax in respect of remuneration derived from foreign employers as this remuneration is not currently subject to the withholding of employees' tax.

Problem identified

Foreign employees of multinational companies who are temporarily seconded to work in South Africa will often remain on their home country payroll. Because the local entity does not pay them, nor is liable to pay them, there is no South African employees' tax withholding obligation on a local entity. The multinational may not even have a South African resident entity, or may only have a non-resident branch, and therefore there is no resident employer or resident representative employer liable for PAYE withholding. These individuals are only taxed on assessment, unless they are provisional taxpayers in respect of other income.

The current definition (of provisional taxpayer) only includes an individual as a provisional taxpayer if the individual doesn't derive by way of income any amount which does not constitute remuneration or a section 8(1) allowance or advance.

Currently, the Commissioner may notify any person (i.e. also an individual mentioned above) that he or she is a "provisional taxpayer" - in terms of paragraph (c) of the definition of provisional taxpayer in paragraph 1. It appears from the draft Explanatory Memorandum that this process is administratively too onerous.

As currently drafted, the amendment will not achieve its stated objective. The definition of "provisional taxpayer" is designed in such a way that the specific inclusions are all subject to the provisos (i.e. "but shall exclude"). Adding an additional specific inclusion will not necessarily ensure that that category of person becomes a provisional taxpayer, as they may still qualify for one of the exclusions. This is particularly the case for the employees envisaged here.

One of the exclusions is for natural persons not carrying on a business, with taxable interest, dividends and rentals of less than R30 000. An expatriate employee working in South Africa is not carrying on a business, and because they are non-resident and generally have no South African sourced investment income, they will almost always qualify for this exemption. As noted above, even if they are named in a public notice under a new sub-para. (d), that inclusion is still subject to the proviso, so they will be excluded from the definition.

On the basis that the intention is that resident (local) employees deriving remuneration in South Africa from non-resident employers should be provisional taxpayers we suggest that the following change to the definition of provisional tax should be sufficient. The amendment should focus on the fact that it is remuneration derived from an employer who is not a resident or an agent (of such an employer) with authority to pay remuneration.

Suggested solution

Paragraph (d), of the definition of provisional taxpayer, should read as follows:

> "(d) any person (other than a company) who derives by way of income any amount which constitutes remuneration from any employer who is not a representative employer or an allowance or advance contemplated in section 8(1);"

Clause 7: amendments to paragraph 9 of the Fourth Schedule relevant to the deduction tables to be used by employers when employees' tax is to be withheld.

Proposed amendment

The clause amends paragraph 9 of the Fourth Schedule to the Income Tax Act, as follows:

> "(1) The Commissioner may from time to time, having regard to the rates of normal tax as fixed by Parliament or foreshadowed by the Minister in his budget statement and to any other factors having a bearing upon the probable liability of taxpayers for normal tax, prescribe–
>
> > (a) deduction tables applicable to such classes of employees as the Commissioner may determine; and
> >
> > (b) the manner in which such tables shall be applied, taking into account the rebates applicable in terms of sections 6, 6A, 6B and 6quat,
>
> and the amount of employees' tax to be deducted from any amount of remuneration shall, subject to the provisions of subparagraphs (3), (4) and (5) of this paragraph and paragraphs 10 and 11 and section 95 of the Tax Administration Act, be determined in accordance with such tables or where subparagraph (3), (4) or (5) is applicable, in accordance with that subparagraph…"

According to the draft Explanatory Memorandum the intention is that “these tables … should take account of all rebates afforded to taxpayers, including those under section 6quat” and that the “new tax deduction tables are implemented by employers as from 1 March of a particular year … subsequent to notification…”

Problem identified

Paragraph 2(1) requires of the employer to withhold employees tax from remuneration. The employees tax must then be determined, amongst others, as provided for in paragraph 9. It is paragraph 9(6) that allows for the rebates to also be taken into account (deducted from the normal tax payable) in arriving at the amount of the employees’ tax.

It currently only allows for the section 6A and section 6B rebate to be deducted. The current version of paragraph 9(1) provides that the Minister must have regard to the rebates applicable in terms of section 6 and section 6quat.

There is no specific provision in paragraph 9 that provides that the rebates must be deducted from the amount of the normal tax in determining the employees’ tax to be withheld.

Suggested solution

That paragraph 9(2) be amended as follows:

> “(2) Any tables prescribed by the Commissioner in accordance with sub-paragraph (1) shall come into force on 1 March of the relevant year of assessment [such as may be notified by the Commissioner in the Gazette], and shall remain in force until withdrawn by the Commissioner.”

Paragraph 9(6) should be amended to also provide that the section 6 rebates (primary, secondary and tertiary) as well as the section 6quat rebate must be deducted.

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Clause 12 – amendments to paragraph 20 of the Fourth Schedule

Proposed amendment

The change to paragraph 20 is made to ensure that "taxpayers are required to pay provisional tax on the other amounts listed in paragraph (d) of the definition of gross income in section 1 (*sic*), because these other amounts are not taxed under the lump-sum tax tables."

According to the draft Explanatory Memorandum, "because these amounts are excluded from the penalty calculation, taxpayers are not penalised if they fail to pay the required provisional tax."

Problem identified

It is correct that these amounts do not constitute severance benefits, but these amounts are remuneration and are subject to employees' tax.

In principle, the underestimation penalty should be imposed when the person underestimated the final taxable income for the relevant year of assessment and also paid insufficient employees' tax and provisional tax.

Suggested solution

The tax on lump sums (according to the special tables) should be excluded from provisional tax as must those lumps sums. The other lump sums must be included in the estimate as must the employees tax withheld on these amounts.

Comments on the Taxation Laws Amendment Bill, 2016

Clause 12: inserts a new section 7C – "Loan or credit advanced to trust by connected person"

General comments

We wish to make some general comments first.

The aim of the new provision, according to the draft Explanatory Memorandum is in the first place, "to limit taxpayers' ability to transfer wealth without being subject to tax". The focus will then be "on interest free loans or loans with interest below market rates that are made directly or indirectly by a natural person, or by a company that is a connected person in relation to that person to a trust".

Comments – not subject to tax

It must be remembered that a transfer of wealth is unlikely to "not be subject to tax". The transfer of an asset with a market value in excess of its base cost will result in a capital gain. If the asset transferred is immovable property or securities, transfer duty or the securities transfer tax would be payable.

It is therefore not correct to say that a transfer of wealth is not subject to tax as the taxes are not avoided by making use of interest free loans. In addition, the Income Tax Act already contains specific anti-avoidance provisions that apply to interest free loans.

Specific comments

Proposed amendment – effective date

In terms of the proposed section 7C(1) the section would find application when the person "makes or provides any loan, advance or credit to a trust".

Under clause 12(2) section 7C is to come into operation on and to apply in respect of years of assessment commencing on or after 1 March 2017.

Problem identified

The wording in clause 12(2) is not clear and may be read that it will apply to loans, advances or credit extended to the trust before 1 March 2017.

Suggested solution

The wording in clause 12(2) should be changed the make it clear that section 7C will only apply when the person "makes or provides any loan, advance or credit to a trust" on or after 1 March 2017. Existing debt should not be caught by the new section.

Problem identified – trust not defined

As was indicated earlier in this submission, the intention was to "limit taxpayers' ability to transfer wealth without being subject to tax". Many trusts are established for reasons other than the avoidance of income tax and Estate Duty. This fact is not recognised in the proposal and it is clear that all trusts will be treated the same.

Benevolent trusts

Trusts established for charitable purposes, the protection of assets for the benefit of minors or the elderly, the maintenance of former spouses and children, and many other benevolent trusts, will be impacted by this proposal. Many of these trusts will not earn the official rate of interest (currently 8%) and will be unable to pay the required interest, nor pay the lender the tax due on the interest. The trust may become insolvent and be unable to achieve its benevolent objectives. Furthermore, the trustees of such trusts would find themselves in the position of having to find a return of at least 8% on trust assets in order to ensure the survival of the trust, forcing them to take investment risks that put the trust in further jeopardy. Tax rules should not drive these outcomes.

Suggested solution

It is admitted that a carve-out or exemption for benevolent purpose trusts would be difficult to define. Consequently, it is submitted that a less punitive proposal be put forward to discourage Estate Duty avoidance. This may require research and it may be appropriate to delay the proposal in its entirety until a solution is found.

Commercial trusts

The proposal is clearly aimed at family trusts funded by individuals, or by their family companies. However, the scope of the provision is so far reaching that it could easily impact many commercial arrangements, such as where a company loans funds to a trust, including BEE empowerment trusts, employee share trusts, and asset protection trusts.

The trigger is merely that the company be connected to an individual who is connected is a connected person in relation to the trust. The definition of "connected person" in section 1(1) of the Income Tax Act is wide and even large companies could find that certain individuals are connected to the company and the trust, for example because they are beneficiaries of the same trust or partners of the same partnership.

Suggested solution

The trigger should be narrowed to ensure that only family trusts are targeted. This can be achieved by using a narrower version of the "connected person" definition.

Problem identified – existing avoidance rules

A low or interest-free loan is, in terms of common law, considered an "other disposition" for the purposes of the section 7 and Part X of the Eighth Schedule. Therefore, failure to charge interest at a market related interest rate on the loan already leads to income or capital gains of the trust being imputed to the lender. The lender will consequently pay normal tax on the income and capital gains generated in the trust by funds from the interest-free and low-interest loan.

There is nothing in the proposal which would prevent both section 7C and the attribution rules, Part X of the Eighth Schedule, from applying to the same loan. An interest-free loan remains an "other disposition" even if section 7C deems interest to be taxable on it. This will result in the same benefit to the trust being taxed twice in the hands of the lender.

Suggested solution

Interest-free loans do not achieve tax avoidance, if the attribution rules are properly enforced. Although transfer of assets diminishes the estate of the disposer, normal tax on the capital gain is paid thereon, so there is no avoidance. Furthermore, the loan is property in the estate of the lender, on which Estate Duty will be paid at death.

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It appears that there is a concern that there is a loss to the *fiscus* of Estate Duty on the subsequent growth, if any, of the asset sold into the trust. In this respect section 3(3)(d) of the Estate Duty Act provides ample ammunition for SARS to attack the avoidance of Estate Duty. If section 3(3)(d) does not apply, then it is submitted that the individual (or the deceased) did not enjoy the benefit of the assets in the trust, and therefore no Estate Duty has been avoided (i.e. the trust property is correctly treated as outside the deceased's dutiable estate).

It does not seem reasonable to create double taxation (section 7C plus the attribution of the capital gain) in order to discourage the use of trusts for Estate Duty purposes, when the transfer of assets is subject to normal tax and the transfer taxes (as was explained earlier) and the loan remains subject to Estate Duty. As noted above, trusts are used for many legitimate purposes other than estate duty in any case.

Problem identified - non-resident trusts

Section 31 (of the Income Tax Act) already applies to loans between a non-resident trust and a resident beneficiary of that trust (or a resident relative of a beneficiary, which would typically include the founder), as they are connected persons. Consequently, such loans must be at arm's length, meaning a market-related interest must be charged.

Section 7C will compare the interest charged on such loans to the official rate, rather than to the arm's length rate. Typically, an arm's length rate would be higher than the official rate for foreign loans in any case, so section 7C would not find application. However, where it did apply there is nothing to prevent both section 7C and section 31 from applying to the same loan, which could lead to an adjustment under both provisions, and a deemed donation under both provisions. This is far too punitive. Failure to apply an arm's length rate of interest on a foreign loan should be dealt with exclusively in terms of section 31.

Suggested solution

Loans to foreign trusts should be excluded from section 7C, and remain subject to section 31. Section 7C would consequently be a domestic transfer pricing rule for local trusts, as seems to be the intention.

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Clause 13: the replacement of section 8C(1A) – Amounts received in respect of restricted equity instruments

Proposed amendment

The current section 8C(1A) seeks to include in income any return of capital in respect of a restricted equity instrument ("REI"). Such a return of capital is considered to constitute an effective vesting of that REI, as some or all of the economic value has been extracted therefrom.

The replacement provision both narrows and extends the provision. It narrows the return of capital inclusion by carving out returns in the form of REIs (which will fall to be taxed in terms of section 8C in any case). It extends the provision by including any amounts received in respect of a REI in income, except (a) the aforementioned returns in the form of REIs, (b) dividends dealt with elsewhere in the Act, and (c) gains or losses dealt with elsewhere in section 8C.

Problems identified

Disincentive to employee share ownership

Section 8C has always sought to tax employee equity as remuneration. It has never sought to provide a tax incentive to reward employees with equity. The only 'concession' that it provides is that it taxes such equity at vesting rather than at acquisition, however it is submitted this is simply an extension of the normal accrual principle of taxation. Such deferral generally results in more tax being paid (i.e. on the share growth) than would otherwise be the case, and results in more tax collected, not less.

Problem identified

The new section 8C(1A) prompts us to pause and reflect as to why the taxation of employee equity should be targeted with such punitive treatment. The alignment of employees with other shareholders in a common goal of shared growth is a positive objective that should be encouraged, not punished. Rewarding employees with a share of that growth should be applauded. Empowering previously disadvantaged workers to becoming part-owners of their employers is a laudable goal and actively encouraged by BB-BEE legislation, but not by tax legislation.

Yet more complex and retroactive amendments to section 8C merely serve to highlight that it is time this legislation was revisited in its entirety, not only with the goal of preventing tax avoidance but of encouraging employee equity participation and alignment with transformation goals.

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Suggested solution

The present amendment should be held over pending a root-and-branch review of section 8C and related provisions. Further complexity introduced ahead of such a review would introduce unnecessary uncertainty.

Repayment of capital contributed

Problem identified

The existing section 8C(1A), and also the proposed replacement, simply includes a return of capital in income. No relief is given for any consideration paid for the share on which capital is being returned, i.e. unlike the rest of section 8C, the gross proceeds rather than the gain is included in income.

Suggested solution

Only the amount returned in excess of the amount contributed should be included in income, i.e. the gain.

Retroactive effect

Problem identified

The provision will apply to amounts received after 1 March 2017, but in respect of REIs acquired before or after that date. The provision therefore seeks to tax amounts received in respect of existing REIs, which were acquired in terms of the current (and historic) rules.

There are two objections to this retroactive effect.

Firstly, taxpayers are under no obligation to arrange their affairs so as to create the largest possible tax burden for themselves. Consequently, employee share schemes have been designed to comply with the law in such a way that the correct amount of tax is paid, but no more. If Treasury and SARS are of the view that taxpayers should pay more tax on certain arrangements then that is their prerogative, however they should exercise such prerogative in a prospective manner and not retrospectively. When the REIs in question were acquired by the relevant taxpayers, such taxpayers knew and understood the tax consequences and were locked into those consequences by section 8C and related provisions.

To now change the rules such that those consequences are different is unfair and unreasonable. Of course, all taxpayers know that the law may change and need to accept that possibility. However, section 8C is designed in such a way that the consequences are locked in from the time of acquisition until the time of vesting. The taxpayer cannot now stop holding a REI. It is, was and will remain an REI until it vests. It is only fair and reasonable that the tax treatment of that REI during its vesting period should remain constant.

A similarity can be drawn to the addition of para. (c) of the definition of equity instrument from 21 October 2008. From that date, contractual rights which derived their value from shares were subject to the provisions of section 8C. However, because section 8C only applies if a right was an equity instrument at acquisition, the amendment was not retrospective (i.e. it did not bring all such existing contractual rights into section 8C, only newly acquired ones). This was, it is submitted, the fair and correct outcome. A similar outcome should transpire with the current proposal.

Secondly, employee share schemes are carefully crafted arrangements and taxation is just one part of the design process. Taxation is, however, crucial to the financial funding model of share schemes. Employee share schemes are commercial arrangements, and must be funded like anything else in business. Often, the schemes are funded with ongoing dividends or occasional disposal proceeds. Funding models require certain assumptions, some of which (rate of return etc) can be adjusted for within a range, and others cannot be. It can never have been expected by plan designers in the past that all amounts accruing in terms of REIs would be subject to income tax, particularly on existing REIs. The net-of-tax basis for the funding model has therefore changed dramatically. It has effectively become more expensive and less attractive to offer equity to employees.

Suggested solution

The amendment should apply only to REIs acquired on or after 1 March 2017.

Interaction with capital gains

Problem identified

The new section 8C(1A) seeks to include any amount received in respect of REIs in income, excluding certain amounts, but not excluding capital gains. Where holders of REIs participle in capital gains as beneficiaries of a trust or partners in a partnership, it is possible that such amounts would fall to be taxed in terms of section 8C(1A). Should this occur, it is unclear how double taxation would be eliminated. The same problem already exists in relation to trusts since the introduction of the amended paragraph 80(1) and the new paragraph 80(2A) and the latest change merely exacerbates the problem.

For example, a trust may dispose of some but not all its shares and the resulting capital gain is vested in the beneficiaries, who hold rights or units in the trust (the units being REIs for the purpose of section 8C). For each share disposed of and resulting gain vested in each beneficiary, one Unit is cancelled. This will trigger paragraph 80(2A), and section 8C(1A), such that the capital gain made by the trust result in a capital gain in the trust (taxed at an effective rate of 32.8%) and the vested amount is included in the income of the beneficiary (taxed at up to 41%). The same amount is therefore subject to a combined tax rate of 73.8%. Furthermore, no tax deduction is available to the employer for the amount taxed as remuneration in the hands of the employee (i.e. there is no matching corporate tax offset), even in terms of the proposed section 8CA.

Suggested solution

Section 8C(1A) should exclude capital gains dealt with in terms of the Eighth Schedule, in the same way that it excludes dividends dealt with in terms of the Income Tax Act.

Overly-wide application

Many of the problems identified herein are a result of the overly-wide application of the provision. It can be understood from the draft Explanatory Memorandum that the provision is largely targeted at arrangements whereby value is extracted from REIs in a form that would not otherwise trigger section 8C, e.g. share buy-backs. The opportunities to do this are extremely limited in the ordinary course of events.

Suggested solution

The provision should be aimed more directly at combatting the specific mischief which has been identified.

If share buy-backs, which generate a dividend, pose a threat to the operation of section 8C, then a specific provision to include the proceeds of such a transaction in the income of the REI holder would solve that problem, with none of the unintended consequences noted above.

Clause 13: the insertion of a new section 8CA – Deduction of expenditure in respect of restricted equity instrument scheme

Proposed amendment

It is proposed that this deduction be spread over the period during which the restriction in respect of the equity instrument applies.

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Problem identified

In terms of the wording in proposed section 8CA(2), the expenditure actually incurred and paid by an employer in respect of a restricted equity instrument scheme must be treated as expenditure incurred evenly over the longest period during which an equity instrument can qualify as a restricted equity instrument in terms of that scheme.

Suggested solution

It is suggested that the deduction be allowed in accordance with its treatment under IFRS.

Clause 24: replacement of section 10(1)(k)(i)(ii) - limitation of dividend exemption in respect of unvested equity instruments

Proposed amendment

Dividends received by or accrued to a person "in respect of services rendered or to be rendered or in respect of or by virtue of employment" are currently excluded from the income tax exemption, in terms of proviso (ii) of section 10(1)(k)(i), unless such dividends are received or accrued in respect of (i) a restricted equity instrument as defined in section 8C or (ii) a share, held by that person.

The current proposal is proposed that proviso (ii) be amended to exclude only dividends from section 8C equity instruments that have vested in terms of that section, and marketable securities as contemplated in section 8A.

Problems identified

The problems identified above in relation to section 8C(1A) also apply here, particularly in relation to retroactive effect.

The provision will apply to amounts received after 1 March 2017, but in respect of REIs acquired before or after that date. The provision therefore seeks to tax amounts received in respect of existing REIs, which were acquired in terms of the current (and historic) rules.

The current version of section 10(1)(k)(i)(ii) specifically permits an employee to receive exempt dividends by virtue of employment in respect of a restricted equity instruments. Share schemes that current exist and pay dividends in compliance with this rule should not now be punished by removing the dividend exemption while the employees still hold such instruments.

Suggested solution

The new version of the proviso should apply only to dividends received in respect of restricted equity instruments acquired after 1 March 2017.

If there are forms of unacceptable avoidance that National Treasury or SARS wishes to curtail, such as dividends from share buy-backs, then a specific provision dealing with such dividends should be introduced, rather than reversing the current rules for every taxpayer in a restricted equity scheme.

Meaning of "by virtue of employment"

Problems identified

The above-mentioned proviso only applies if a dividend is received in respect of services rendered or by virtue of employment. Many taxpayers will argue that a dividend is paid in respect of a share or other instrument and not in respect of services or employment. This argument has considerable merit, supported by case law, and SARS will face a barrage of challenges on this front, it is predicted. After all, how can an amount be received in respect of a restricted equity instrument on the one hand, for the purposes of section 8C(1A), but also be received by virtue of employment, on the other hand, for the purposes of section 10(1)(k)(i)(ii)? This method of dealing with employee-equity derived dividends is not workable in practice.

It has also been suggested that a dividend can only be received "in respect of employment" if it is paid on a special class of shares held only by employees, or as a corporate distribution triggered by some kind of employee performance target being met. If this is the intention of the legislation, then it needs to be made far more explicit than at present.

Suggested solution

It should be accepted that dividends are never received in respect of employment, and that the basis of the proviso is unsupported by the common law. The attempt to tax dividends as remuneration should be discontinued. The employee will pay income tax on the equity awarded, in terms of section 8C, and any dividends received will be dividends in the ordinary course. If there are specific areas of abuse, such as share buy-backs, these should be targeted with specific provisions.

Problem identified - Practical difficulties with the withholding of employees' tax instead of dividends withholding tax

Employee share schemes of listed groups are often structured on the basis that shares in the listed holding company underpins the restricted equity instruments held by the employees of the subsidiary companies.

The employee share schemes of many listed groups of companies use the services of regulated intermediaries, particularly central securities depository participants (CSDPs), to administer the payment of dividends to the employees. The systems of the CSDPs are set up to withhold dividends withholding tax at 15% from all dividends paid to individuals.

The proposal that employees' tax instead of dividends withholding tax must be withheld from dividends declared on restricted equity instruments is likely to cause significant practical complications. Firstly, the CSDP would have to know which of the shareholders are holding the shares as restricted equity instruments (subject to employees' tax) and which of the shareholders are holding them as unrestricted equity instruments (subject to dividends withholding tax). Secondly, the CSDP would have to know what the marginal tax rate of each employee is although it would not be practical to obtain tax directives from SARS each time.

Suggested solution

Careful consideration will have to be given to the practical aspects regarding the other employees' tax compliance obligations.

Clause 19 - amendment to section 10(1)(gC) and source rules

Proposed amendments

It is clear that the concern is that South African tax residents, who work outside South Africa, can receive a tax deduction on contributions made to a South Africa retirement fund either in the same tax year if they have other forms of taxable income or worked partially within that year or the amounts can be rolled over to be deducted in a future year of assessment. However, upon receipt of the retirement benefits the amount that accrued while the South African tax resident was employed outside South Africa will be free from tax.

Problem identified

The proposal is contrary to the binding general rule (BGR025) and constitutes a retrospective change in tax policy and tax law for the following reasons:

Firstly, pensioners, who have already retired and who have been receiving a pension in respect of both South African and non-South African services, have contributed to South African approved funds based on the accepted interpretation of section 10(1)(gC) (as confirmed in BGR025) and have subsequently been paying tax only on the non-South African service element.

The proposed change would mean that they will be financially penalised, perhaps severely so if said pension is their only or main source of post-retirement funding, although having acted fully in accordance with the law and interpretation applicable during their membership of the pension fund concerned. Further, there will be a discriminatory effect in that pensioners, who elected to take a lump sum commutation, would have been able to benefit from the current 'sourcing' provisions as opposed to pensioners who elected to take a full pension.

Secondly, the interaction with section 10(1)(o)(ii) does not seem to be fully considered. Up to 28 February 2016, contributions to approved pension funds would not have been possible where individuals qualified for said exemption as 'other income' did not constitute retirement funding employment income. Given the deduction limits imposed by section 11(k), future roll-overs will be limited.

Suggested solution

The proposed changes should only be made applicable to benefits received from an approved pension or provident fund in respect of contributions made on or after 1 March 2017.

Clause 27 – amendments to section 11(k) of the Income Tax Act

The Explanatory Memorandum provides the following detail:

> "I. Background
>
> Previously, deductions to retirement annuity funds were only allowed to be set off against "non-retirement funding income" (which included passive income such as interest or royalties, but excluded taxable capital gains), while deductions to pension funds could only be set off against "retirement funding income" (which represented income from employment and did not include passive income).
>
> II. Reasons for change
>
> The harmonisation of the tax treatment of contributions in section 11(k) allowed for a deduction against income from "carrying on a trade", which unintendedly excluded passive income. This resulted in members of retirement annuity funds who were using the deduction against passive income to no longer able to deduct their contributions against the passive income.
>
> III. Proposal
>
> In order to correct this anomaly and to allow retirement annuity members to continue to receive a deduction and fully align the treatment between all retirement fund members, it is proposed that deductions for contributions to all retirement funds should be allowed to be set off against passive income. For the purpose of the section 11(k) deductions, the passive income does not include taxable capital gains."

Our comments

It is important to remember that the total of the contributions allowed as a deduction for the year is currently limited to an amount of R350 000.

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Section 11(k), as was introduced by Act No. 31 of 2013 and as it applies from 1 March 2016, limits the deduction available annually to 27,5% of the higher of remuneration (in (A)) or taxable income in (B)). For both, remuneration and taxable income, it excludes “any retirement fund lump sum benefit, retirement fund lump sum withdrawal benefit and severance benefit”. It is only with respect to the ‘taxable income’ that it requires the amount to be determined before allowing any deduction under section 11(k).

It is true that the deduction in respect of contributions to pension funds was, before 1 March 2016, limited to “7,5 per cent of the remuneration (being the income or part thereof referred to in the definition of ‘retirement-funding employment’ in section 1) derived by such person during such year in respect of his or her retirement-funding employment”. Part (B) maintains this principle when it limits the deduction to 27,5% of remuneration – in other words, it doesn’t include ‘passive income’.

The consequence of this is that the individual, if his or her remuneration is higher than his or her taxable income, will make the deduction under section 11(k)(i)(bb)(A) (where the R350 000 limit doesn’t apply). The proposed amendment doesn’t amend section 11(k)(i)(bb)(A) – in other words, it doesn’t add ‘passive income’ to remuneration and correctly so. For an individual who has ‘passive income’ the position would be that this income will form part of the person’s taxable income. It may therefore not be necessary to add ‘passive income’ to remuneration as it would be included in taxable income. It would however, exclude passive ‘income’ such as dividends (which are exempt from normal tax and therefore not part of ‘income’ as defined for tax purposes).

In terms of the definition in section 1(1) of the Income Tax Act “taxable income” means “the aggregate of—

(a) the amount remaining after deducting from the income of any person all the amounts allowed under Part I of Chapter II to be deducted from or set off against such income; and

(b) all amounts to be included or deemed to be included in the taxable income of any person in terms of this Act.”

The amounts to be included (see paragraph (b) above) include the ‘unspent’ portion of section 8(1) allowance and of course a taxable capital gain.

The current (or the after 1 March 2016) wording of section 11(k) requires an amendment as there is an ambiguity with respect to the order when the taxpayer applies the 27,5% (for section 11(k)(i)(bb)(B) purposes) and the 10% (where a section 18A donation was made during the year). Both of them refers to “taxable income … as determined before allowing any deduction under this paragraph” (section 11(k)) or “this section” (section 18A(1)).

As there is no specific reference to the “amounts to be included or deemed to be included in the taxable income”, the ‘taxable income’ would include a taxable capital gain. This is in accordance with SARS’s view as it is stated in paragraph 23.4.5 of their CGT guide that “it follows that taxpayers will be able to claim 10% of any taxable capital gain in determining the allowable portion of any qualifying donations, with any excess being carried forward to the succeeding year of assessment.” With respect to contributions to retirement funds, the R350 000 limit, would limit the section 11(k) deduction in a year where the taxable capital gain is substantial.

It is not clear why a taxable capital gain can’t be included in taxable income for purposes of the section 11(k) deduction. An example of where this would be appropriate is where a person derives dividend income from shares in the RSA. The dividends (passive income), other than being subject to the dividends tax, is exempt from normal tax. If the individual funds contributions to a retirement fund from these dividends (passive income) it may not qualify to be deducted as the amount of the dividends is not included in taxable income. A capital gain, or portion thereof (40%), made when the shares are sold, is included in taxable income and there is no reason why the person should not be able to fund the contribution from the capital gain and get a tax deduction.

The draft Bill states that “section 11 of the Income Tax Act, 1962, is hereby amended by the addition in (*sic*) to the proviso to paragraph (k) after paragraph (iv) of the following paragraph:

> “(v) any deduction in terms of this paragraph must apply for the purpose of determining the total amount of taxable income, before any deduction in terms of section 18A or the inclusion of any taxable capital gain of the person, whether derived from the carrying on of any trade or otherwise;”.

The wording solves the issue relating to the order of the deductions and we agree that the reference to the fact that it was “derived from the carrying on of any trade or otherwise” is necessary. But it introduces a new limit by excluding the taxable capital gain which the current wording does not. It is not clear if the policy in this regard changed to exclude taxable capital gains from taxable income for purposes of the section 11(k) deduction.

Suggested solution

It is suggested that item (B) of section 11(k)(i) should read as follows:

> “taxable income (other than in respect of any retirement fund lump sum benefit, retirement fund lump sum withdrawal benefit and severance benefit), whether derived from the carrying on of any trade or otherwise, as determined before allowing any deduction under this paragraph and section 18A;”.

Clauses 23 and 46 – Section 9HA, section 22(8) and section 25 of the Income Tax Act

The amendments aim to "clarify the tax consequences for the surviving spouse regarding allowable deductions and allowances in respect of those assets (e.g. deductions and allowances in respect of mining, farming and forestry assets) as well as the subsequent capturing of any recoupments in the hands of the surviving spouse." With respect to section 22, it also refers to "deductions and allowances in respect of mining, farming and forestry assets."

In principle it is agreed that there should be a roll-over. In other words, the deceased should not have any tax consequences in respect of assets that passes over to the surviving spouse.

Problem identified

The deletion of the reference to section 9HA in section 22(8) may not achieve the stated intention. The current wording, of section 22(8), is that the deceased is treated as having disposed of the trading stock, not at market value, but at the expenditure allowed. This would in most instances mean that it is disposed of "for a consideration less than the market value thereof" as envisaged by section 22(8). As the disposal, under section 9HA, can't be said to have been "in the ordinary course of" the deceased trade, section 22(8)(B) would then require that the market value at date of death is recovered or recouped.

Suggestion solutions

Section 22(8) should not apply where the trading stock passes from the deceased spouse to the surviving spouse. Section 22(8)(ii) should read, "… taxpayer has disposed of trading stock, other than in the ordinary course of his or her trade or other than as contemplated in section 9HA(2)(b)(i) …"

Paragraph 11©(B) of the First Schedule should similarly be amended.

Clause 68(a) - amendments to paragraph 12D of the Seventh Schedule

Triggering the application of the fringe benefit in the case of contribution holidays in defined benefit and related retirement funds

Problem identified

According to the draft Explanatory Memorandum and the Budget Review, 2016, the intention is to subject to tax (in the form of as taxable or fringe benefit), not only contributions made by employers for the benefit of employees to retirement funds with a defined benefit component, but also contributions made by such retirement funds on behalf of the employer by the fund. We understand that contribution holidays, common in defined benefit funds would currently not result in a fringe benefit, and that this specific type of loophole is being targeted.

The objective stated in the draft Explanatory Memorandum, is that the formula in paragraph 12D of the Seventh Schedule, used to calculate the value of the taxable benefit in the case of fund with a defined benefit component, should incorporate the value of, for instance, such a contribution holiday.

In our opinion, the current wording proposed for paragraph (a) of the definition of "retirement funding income" in paragraph 12D of the Seventh Schedule does not meet the stated objective.

Proposed solution

We propose that a proviso be added to paragraph 2(I) of the Seventh Schedule, in order to ensure that the calculation in paragraph 12D(3) of the Seventh Schedule is triggered and apply to determine the value the fringe benefit even where the funding to provide the benefit stems from the retirement fund itself (i.e. from a reserve account), instead of from the employer.

The following wording is proposed:

> "2. For the purposes of this Schedule and of paragraph (i) of the definition of "gross income" in section 1 of this Act, a taxable benefit shall be deemed to have been granted by an employer to his employee in respect of the employee's employment with the employer, if as a benefit or advantage of or by virtue of such employment or as a reward for services rendered or to be rendered by the employee to the employer–

(l) the employer has made any contribution for the benefit of any employee to any pension fund, provident fund or retirement annuity fund: Provided that where the benefits payable to members in respect of a fund member category of a pension, provident or retirement annuity fund consists of components other than only defined contribution components, the employer shall be deemed to have made a contribution in any year of assessment where an allocation has been made from the reserve account in the retirement fund for the purposes of subsidising the employer's contribution."

Retrospective application

Problem identified

The effective date for the proposed changes in terms of clause 68(a) is 1 March 2016. We submit that the retrospective effect would result in practical problems with payrolls already having been run and employees' tax payments having been made to SARS. The resultant interest and penalties could not be justified as being fair under the circumstances.

Suggested solution

We propose that the amendment should only be effective from 1 March 2017 in order to allow employers (and payrolls) to adequately address the matter and process the taxable benefit in the correct period.

Clause 65 clause 68 and clause 27 – Inserting of the definition of "partner" in the Seventh Schedule to Income Tax Act:

Proposed amendment

A paragraph (2A) is to be added to the Seventh Schedule and would apply for the purposes of paragraph 2 of the Schedule. It will deem a partner is deemed to be an employee of the partnership.

Problem identified

There is specific concern that this may have other consequences on partners in general. It would cause problems with other taxable benefits where the partner is not, at common law, an employee of the partnership.

Suggested solution

As the purpose of this amendment is to provide "clarity that for purposes of the application of fringe benefit tax" in the context of contributions to funds, the suggestion is that the clause should only apply for purposes of paragraph 12D.

SAIT thanks National Treasury and SARS for the opportunity to comment on this very important matter and would welcome further dialogue.

Yours sincerely,

Piet Nel