South African Institute of Tax Professionals

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The National Treasury

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The South African Revenue Service

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RE: DRAFT TAXATION LAWS AMENDMENT BILL (TLAB), 2016: COMMENTS PERTAINING TO KEY BUSINESS TAX ISSUES

We have attached the comments from the SAIT Business Tax Technical Work Group on the draft Taxation Laws Amendment Bill pertaining to key business tax issues. We appreciate the opportunity to participate in the process and would welcome further dialogue.

Please do not hesitate to contact us should you need further information.

Yours sincerely

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Chair of the Business Tax Technical Work Group

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COMMENTS PERTAINING TO KEY BUSINESS TAX ISSUES

1. CROSS-BORDER HYBRID DEBT INSTRUMENTS

Treasury Proposal

It is proposed that the anti-avoidance rules in section 8F should only apply in instances where the issuer is a resident company or in the case of a non-resident company only in respect of a debt instrument that is solely attributable to a permanent establishment in South Africa or a controlled foreign company whose profits are attributable to a South African resident.

Issues

As is evident from this proposal, these anti-avoidance provisions have mainly been used against Government and have little impact on various hybrid debt schemes. These provisions are easy to plan around if professional advice is sought in advance. They are instead a trap for the unwary taxpayer who have no avoidance schemes in mind.

Recommendation

We recommend that section 8F should be repealed in its entirety to address these concerns. Consideration could rather be given to introducing anti-avoidance provisions to specifically address cross-border hybrid debt instruments that result in the erosion of our tax base as suggested by the Davis Tax Committee.

../3

2. HYBRID DEBT INSTRUMENTS SUBJECT TO SUBORDINATION AGREEMENTS

Treasury Proposal

It is proposed that the re-classification feature of the anti-avoidance rules should not apply in the instances where an issuer owes an amount to a company that forms part of the same group of companies as the issuer and where payments in respect of that amount owing are suspended due to the financial difficulties of the issuer.

Issues

The proposed amendment is welcomed. However, we are concerned that it will not adequately assist many companies who have inadvertently triggered these anti-avoidance rules in the past. As indicated, the subordination of inter-company loan agreements are often necessitated to ensure that auditors can sign off that the borrower is a going concern. Furthermore, the standard format of subordination agreements recommended by many audit firms to their clients in recent years contain a solvency test which would have brought the loan into the definition of a hybrid debt instrument from 1 April 2014. This format was driven solely by audit considerations without regard to tax.

The relief provided by the proposed amendment is limited to instruments issued within the same group of companies as defined in section 41 of the Income Tax Act ("ITA"). In practice, subordination agreements are not only entered into between companies that fall within the narrow definition of a group of companies but between various other connected persons.

A further concern is that the application of the solvency and liquidity tests as envisaged in section 46 of the Companies Act in order to determine to what extent an amount of interest must be deemed to be a dividend *in specie* is complicated and subject to judgement.

../4

Recommendation

We recommend that the relief should be provided in all instances where both parties to a subordination agreement are residents. Given the reason for the proposal, namely to assist financially distressed companies who were compelled to enter into subordination agreements, we recommend that the amendment should have retrospective effect to 1 April 2014 when section 8F became effective.

Other comments

The proposed definition of “third party backed instrument” refers to an “enforcement obligation” or “enforcement right" as defined in section 8EA(1). These terms are defined in relation to the holders of a “share” and not an “instrument”, thereby causing confusion. We recommend that these terms should specifically be defined for purposes of section 8F. It is also not clear to us what the purpose of the proposed amendment is and whether it will be achieved.

Sections 8F and 8FA recharacterise interest as a dividend in specie. There is some uncertainty whether the section 64FA exemption from dividends tax is available to a resident company which pays interest to another resident company and which is recharacterised as a dividend in specie. We recommend that a definition of “beneficial owner” be inserted for purposes of sections 8F and 8FA in order to make it clear that the holder of the instrument is regarded as the beneficial owner for purposes of the dividends tax.

../5

3. **EXTENDING THE SMALL BUSINESS CORPORATION REGIME TO PERSONAL LIABILITY COMPANIES**

Treasury Proposal

It is proposed that personal liability companies should expressly be included in the definition of “small business corporation” contained in the Income Tax Act in respect of years of assessment ending on or after 1 January 2017.

Issues

The proposed amendment is welcomed as it addresses the anomaly created by the exclusion of personal liability companies from the definition of private company in the 2008 Companies Act, going forward. However, it does not address the unintended consequences arising since the coming into effect of the Companies Act which left personal liability companies at a disadvantage.

Recommendation

We recommend that the amendment should be made effective from the coming into effect of the 2008 Companies Act on 1 May 2011. We realise that National Treasury and SARS are largely reluctant to date amendments back retroactively but retroactive relief is not unheard of.

Many small firms were caught wholly unaware of the unintended anomaly and would have fought against the change had they known. The five year gap will leave many small business owners with substantial penalties and interest as well as a multi-year liability that was never intended.

Given that SARS has only begun to audit the issue (with the issue being newly raised in a recent draft interpretation note), we doubt that retroactive relief will give rise to any refunds.

../6

4. ASSET-FOR-SHARE TRANSACTIONS FOR NATURAL PERSONS EMPLOYED BY A COMPANY

Treasury Proposal

It is proposed that only asset-for-share transactions involving personal liability companies should qualify for tax relief. It is explained that this is because professional service providers such as doctors, lawyers and accountants, for whom the benefit was initially intended, operate as personal liability companies after incorporation.

Issue

Section 42 asset-for-share roll-over relief serves to prevent tax considerations from discouraging the incorporation of a business. It is, therefore, often applied by individual owners of small businesses when they join larger companies that have significant capital (with the small business owner becoming an employee of the new venture).

The roll-over relief is also used in black economic empowerment transactions in share-for-share transactions where the empowerment service-providers will hold only small percentages of the shares in the acquiring company. The basic fact pattern is as follows: A company has issued 26% of its shares to BEE shareholders who are black management. The company is now subject to an acquisition transaction in terms of which a new holding company will acquire the shares in the existing company. The intention is that the BEE management shareholders (who lack further capital) will remain unchanged and that their percentage shareholding in the new holding company will be 26%. This is easy to achieve on a tax-neutral basis if section 42 relief is available. If section 42 relief is no longer available and assuming that the BEE management shareholders each hold less than 10% of the shares, they would now only be able to reinvest the after-tax proceeds on the disposal of the existing company shares into the new holding company.

../7

This not only dilutes their economic participation but also the company's empowerment credentials for BEE partners who are actively participating in the company as desired by the BEE charter codes.

Limiting the relief to personal liability companies could result in upfront tax costs which could adversely affect these other transactions.

Recommendation

We are of the view that the proposed amendment is going in the wrong direction. Section 42 should apply despite the 10 per cent minimum requirement as long as the contributor is a full-time employee of the acquiring company. The nature of the acquiring company business is irrelevant.

5. REFINING THE TAX IMPLICATIONS ON OUTRIGHT TRANSFER OF COLLATERAL PROVISIONS

Treasury Proposals

It is proposed that the legislation be amended to extend the allowable period within which the identical shares are returned to the borrower by the lender from the date on which the collateral arrangement was entered into from 12 to 24 months. In addition it is proposed to broaden the definition of "identical share" to cater for other specified corporate actions and to include listed government bonds as allowable instruments in collateral arrangements.

Issues

The extension of the tax relief on collateral arrangements is welcomed. We believe that there is still some room for accommodating the banks going forward. The inclusion of bonds issued by the government of the Republic in the national or local sphere does not appear to included bonds issued by state-owned enterprises such as Eskom and Transnet.

../8

South African banks also hold large amounts of non-SA government bonds which are not included in the amendment.

Recommendations

We encourage the gradual extension of the relief provided to assist banks in meeting their regulatory requirements. We recommend that the relief available for bonds issued by the government of the Republic in the national or local sphere should be extended to include bonds issued by state-owned enterprises such as Eskom and Transnet as well as non-SA government bonds which are not included in the amendment.

6. ADDRESSING CIRCUMVENTION OF ANTI-AVOIDANCE RULES DEALING WITH THIRD PARTY BACKED SHARES

Treasury Proposal

It is proposed that amendments be made in the definitions of “hybrid equity instrument” in section 8E as well as “preference share” in section 8EA to include any right or interest where the value of that right or interest is directly or indirectly determined with reference to an underlying share with certain debt-like characteristics.

Issue

We are of the view that the anti-avoidance measure is too broad and that it may have unforeseen and unintended consequences. In addition, the amendments will apply with effect from any year of assessment *ending* on or after 1 January 2017. This may mean that taxpayers with year-ends other than December will be affected retrospectively when the legislation is promulgated.

../9

Recommendation

We recommend that the anti-avoidance measure should be more specific in order to target the trust structures that give rise to the concerns. In addition we recommend that the amendment should rather apply with effect from any year of assessment *commencing* on or after 1 January 2017 so that it will not have a retrospective effect.

7. REFINING THE ENABLING REGIME FOR START-UP VENTURE CAPITAL COMPANIES (VCC)

Treasury Proposal

In order to create a more enabling environment for venture capital companies, it is proposed that the connected person test first be performed 36 months after the first shares are issued by the venture capital companies and thereafter at the end of every year of assessment.

Issue

We welcome the proposal as it should assist the current regime. However, we are not confident that the amendment of the current regime will convince a meaningful number of potential investors to invest through the venture capital company regime. The current design of the venture capital company regime does not enable venture capital companies to attract investors as intended. Of the 36 venture capital companies which had been approved by SARS by July 2016, we understand only a few are operating as intended. Many of the venture capital companies are not able to raise the funds required by their funding models and have only attracted limited funds, if any.

../10

A significant reason why the venture capital companies are struggling to attract investors is because it is often tax inefficient for an individual to invest in qualifying company shares through a venture capital company. This is the case because the venture capital company will suffer capital gains tax on the disposal of its shares in the qualifying company and the individual will suffer dividends withholding tax on the dividends distributed by the venture capital company. The effective tax rate on the growth in the value of the investment will be 34%. If the individual invests directly in shares it would only suffer capital gains tax and the effective tax rate on the growth in the value of the investment will be a maximum of 16.4% (based on the individual marginal tax rate of 41%).

The upfront deduction of the amount invested in the venture capital company may seem like an attractive tax incentive for investors in venture capital companies. However, venture capital investors expect a return of more than 30% per annum given the risk attached to these investments. At growth rates higher that 19%, an investor would be better off investing directly into the underlying investments as the adverse impact of the higher effective tax rate on the growth in the value in the investment will negate the benefit of the upfront tax deduction.

Recommendation

We recommend that the venture capital regime should be reviewed and redesigned so that it will achieve its objectives. The multiple levels of taxation should be addressed, possibly by exempting the venture capital companies from capital gains tax on the disposal of their investments in qualifying shares or by introducing fiscally transparent vehicles.

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