THE ETHICS INSTITUTE

sait 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: 2016 TAXATION LAWS AMENDMENT BILLS: COMMENTS FROM MEMBERS (INTERNATIONAL WORKING GROUP)

We are responding to the request for submissions from the public as announced in the 8 July 2016 National Treasury media statement. This response addresses the proposals relating to international taxation.

1. Removal of losses from the high-taxed exemption

We disagree with the proposed removal of the loss adjustment when applying the high-taxed exemption from section 9D (proposed deletion of paragraph (ii)(bb) to the further proviso of section 9D(2A)). We fail to see the perceived avoidance associated with the loss provision, which properly takes into account standard practice in developed (high-taxed) systems.

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- *Bill goes beyond explanatory memorandum:* The complete removal of paragraph (ii)(bb) of the further proviso goes beyond the "group" concern raised by the explanatory memorandum. The complete removal of this further proviso instead eliminates all prior losses even those losses stemming from the same CFC.

  For instance, assume a CFC (subject to a 35% tax rate) has excess losses of 90 in Year 1 and has income of 100 in Year 2. Under the proposed change, the total profits over two years is only 10 so the total tax should be only 3.5 (100 – 90 (x 35%)). Under current law, the high-tax exemption applies because a 35% charge applies to 10 of genuine profits. With the elimination of the further proviso, the 35% charge must apply solely to the second year profits and it will result in the high-tax exemption being failed.

  This result is unfair, hitting many start-up CFCs and CFCs undergoing temporary downturns. Differences in deductions between South Africa and other countries typically do not stem from harmful tax practices. Many countries provide depreciation deductions but at different rates and/or times. Some countries allow for carry-backs. Other deviations are possible (for example, if a loss is insured, South Africa denies the loss while certain other countries will allow for the loss upfront, followed by a recoupment).

- *Where is the avoidance?:* We see no harm in the current further proviso. Foreign group loss offsets are typically allowed only within a group of companies within the same country. Group taxation, including group loss offsets, recognizes that multiple companies within a single group are akin to branches. While South Africa does not have group relief, the section 9D system has historically recognised the legitimate use of group taxation by many foreign countries (see the "business establishment" definition). In essence, the example of the avoidance is wholly unconvincing and shows a complete misunderstanding of group relief.

../3

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Group tax relief for CFCs is important. Many developed countries allow for group tax relief, such as Australia, France, Germany, Spain, the United Kingdom and the United States. These countries have relatively high tax rates. Holding companies and domestic treasury operations are common even though all members of the group are subject to the same level of taxation. Separation of companies is driven by commercial / company law realities – not for tax reasons. The removal of group relief will unfairly penalise operations abroad when many South African multinational foreign operations in these regions are struggling.

From the example, it appears that Government has uncovered some form of mischief associated with a Netherlands CFC (based on the reference to fiscal unity). If there is some form of avoidance specifically associated with Netherlands, we suggest the amendment be more targeted to prevent the abuse.

2. Loans to trusts (proposed section 7C)

We have no objection to proposed section 7C from a cross-border perspective given that connected person loans are already subject to transfer pricing. We would, however, suggest that cross-border loans be subject to only one regime. Our preference is the new section 7C because the new regime provides greater certainty than transfer pricing. No reason exists for loans of this kind to be subject to both regimes, and the new regime is essentially seeking to impose an automatic transfer pricing result.

From a cross-border perspective, the amendment is largely supported with a few minor adjustments:

- *Implementation date:* The implementation date is unclear. Presumably, the mere existence of a no-interest / low-interest loan, advance or credit from 1 March 2017 will trigger the anti-avoidance rule. If so, we think this result is quite harsh for pre-existing loans. We suggest that the effective date for pre-1 March 2017 loans be deferred for at least one year so that taxpayers have time to unwind these structures.

../4

- *Part-years / timing:* Not all loans to trust exist for an entire year of assessment. Loans may be created mid-year or terminate mid-year. Presumably, the deemed rate of interest should reflect (i.e. be reduced) for trust loans that are outstanding for less than a full year of assessment. More notably, when is the section 7C inclusion? Is the section 7C amount included at year-end or on a daily basis? We would suggest a daily inclusion so that the part-year problem is fully addressed without the need for special rules.

- *Clarification of the three year starting point:* It is unclear how to apply the "deemed donation three-year recovery rule" of section 7C(4) in the case of pre-existing loans. Technically, the recovery rule is a simple 3-year rolling rule that can apply as early as 2017 for loans in existence from 2014/15. This form of application appears retroactive. Section 7C(4) should instead have a delayed effective date that starts three years later (i.e. 1 March 2020).

- *Threshold for connected person trusts:* The threshold for connected person trusts is far too low. Not all trust interests should trigger a connected person relationship. We are especially concerned about section 8C trusts for employees (i.e. BEE share schemes can entail no-interest loans). The target of section 7C is mainly family schemes as opposed to section 8C employee schemes (especially involving rank-and-file employees or BEE communities).

3. Foreign currency proposals

A. Foreign currency and reorganisations

We fail to see why built-in foreign currency gains / losses stemming from section 24I(10A) should be excluded from reorganisation relief. The argument that currency gain / loss is equivalent to interest is wholly unconvincing. This form of built-in gain / loss is no different than any other form of built-in gain /loss that one would encounter with trading stock or capital assets.

../5

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Interest on the other hand is taken into account for tax purposes on a yield to maturity /straight line basis. Exchange differences are subject to (unpredictable) exchange rates that can move in both directions, e.g. current unrealised losses can be reversed and become gains in future and vice versa. If an avoidance scheme exists, the specific nature of the scheme should be closed. In this vein, we suggest that section 103 be extended to cover built-in gain / loss asset transfers. This remedy would be more principled and would target all built-in gain / loss concerns, not merely specific schemes of concern under section 24I(10A).

B. Bad debt recovery

We believe that the amendment may be too generous. The bad debt amount should only account for the net currency gain associated with the bad debt over the years – not just the gross final amounts.

For instance, assume that the debt generates a R120 currency loss in 2015 and is associated with a currency gain of R300 in 2016 when the debt is written off. Under the proposal, the section 11(i) amount allows for the deduction of the full R300 when only the net amount of R180 should be reversed. Therefore, we suggest the amendment be limited to the net gain associated with the bad debt write off over the life of the loan as opposed to an adjustment solely to the final currency gain inclusion.

We also note that the bad debt write off of section 11(i) is only part of the story in terms of debts. Similar issues exist on the debt side in terms of paragraph 12A of the 8th Schedule and section 19 when debts are cancelled. We are also experience problems in terms of paragraph 56 when cross-border loans are cancelled, leaving only one side of the equation in the tax net. These and other issues will be raised in our subsequent Annexure C submissions.

../6

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4. Hybrid debt instruments

We note that the proposal under section 8F provides relief to group loans when the perceived hybrid nature of the loans is associated with balance sheet or cash-flow insolvency (paragraph (b) of the "hybrid debt instrument" definition). This relief is limited to domestic groups.

While we understand the use of the domestic group limitation in terms of base erosion and profit shifting, we note that many of these under-water loans continue to exist in order to support South African capital investment. Many of these loans offer no tax avoidance opportunity, giving rise to ordinary interest income in the creditor country. We would instead suggest that the paragraph (b) limitation be wholly dropped and the focus be shifted to debts that are deductible in South Africa but treated as giving rise to dividends in the creditor country.

5. Foreign dividends and share schemes

Given the recent changes to dividends associated with share schemes, we ask the question whether these changes have been synchronised with the rules for foreign dividends. We suggest that section 10B(6) and other aspects of section 10B be co-ordinated with the proposed changes to domestic share schemes under section 8C.

Yours sincerely

Elandre Brandt

Chair of the International Tax Committee