6 November 2017

The Standing Committee on Finance

Parliament of the Republic of South Africa

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RE: 2017 TAXATION LAWS AMENDMENT BILL – URGENT TECHNICAL CORRECTIONS REQUIRED

1. Introduction

Following the tabling of the 2017 Taxation Laws Amendment Bill (TLAB) in Parliament on Wednesday, 25 October 2017, we have identified certain matters which we would like to highlight before the TLAB is promulgated. We are of the view that these matters should be dealt with in this legislative cycle to prevent unnecessary disruption and uncertainty for business. These matters involve technical corrections and unintended consequences.

2. Commencement dates to be provided for all sections

The TLAB does not consistently provide commencement dates for all the sections that are being amended. It also does not appear to make provision for a general commencement date. This is likely to lead to unnecessary uncertainty in the interpretation of the amendments as different amendments could have different triggers e.g. dividends declared versus paid on or after the effective date. As far as possible, each section should have a specific commencement date with the appropriate trigger so that the general commencement date should only serve as a safety net.

3. Amendment of definition of “controlled foreign company” (in section 9D of the Income Tax Act)

The substituted definition of “controlled foreign company” is not split between paragraphs (a) and (b). We gather the new addition of “any foreign company where the financial results of that foreign company are reflected in the consolidated financial statements, as contemplated in IFRS 10, of any company that is a resident,” should be paragraph (b). The reference to paragraph (b) in the further proviso of section 9D(2) that refers to paragraph (b) of the definition will then make sense. The current wording appears to make the amendment a nullity.

4. Innocent commercial transactions hampered by wide impact of new dividend stripping rules (amendment of s22B and par 43A of the Eighth Schedule to the Income Tax Act)

The new dividend stripping rules have a much wider impact than the mischief that they seek to address. The mischief is essentially that the seller of shares in a company receives a tax-exempt dividend instead of taxable proceeds. The transactions typically have two steps – a purchaser contribution followed by a dividend / buyback for the seller. These dividends are funded, directly or indirectly by the purchaser of the shares. We understand the government concern that this provision must be drafted widely to prevent the various forms of mischief involved. Unfortunately, the proposed new dividend stripping rules go too far and adversely impact wholly innocent transactions that should be fully allowed as a policy matter.

There are a number of wholly innocent commercial transactions that are being adversely affected that do not involve any outside purchaser. These affected transactions include corporate shareholders that are involved in:

- Straight-forward share buybacks
- Straight-forward liquidations
- Double distributions in specie (i.e. unbundling-type distributions)

We note that these problems have emerged upon an early reading of the new provision. We suspect other corporate transactions may be adversely impacted (e.g. mergers with corporate shareholders).

Example: Straight-Forward Share Buyback (Redemptions)

Facts: Parent Company owns 700 ordinary shares of Subsidiary and BEE Company owns 300 shares of Subsidiary. Assume that all companies are domestic; the shares are valued at R1 million each; and the ownership structure has existed for 5 years. . What happens if Subsidiary buys back 10 per cent of its shares from either shareholder company and no further transaction takes place?

Outcome:

Pre-2017 TLAB: Both share buybacks would be treated as a dividend under the section 1 definition (unless a capital distribution is chosen). Dividends between domestic companies are tax-free. No losses will result upon the corresponding disposal of the shares (see paragraph 19(1) of the 8th Schedule).

2017 TLAB: The share buyback itself triggers new paragraph 43A, thereby converting the tax-free dividend into a taxable transaction. This outcome applies even though no external funding is involved. In effect, each shareholder of Subsidiary is "disposing of shares in another company", and there is an "exempt dividend received by or accrued to that company [is] in respect of the share disposed of". The dividend will be "extraordinary" because the full value of the shares are fully distributed in a buyback.

Example: Straight-Forward Liquidations

Facts: Parent Company owns all 70 ordinary shares of Real Estate Subsidiary and Minority Company owns 30 shares. Real Estate Subsidiary has a R25 million value. Real Estate Subsidiary liquidates. As part of the liquidation, Parent Company and Minority Company surrenders all of its shares in Real Estate Subsidiary in exchange for all Real Estate Subsidiary assets.

Outcome:

Pre-2017 TLAB: The distributions would be treated as dividends (unless capital treatment is chosen), which are exempt if paid to company shareholders. The distribution also did not trigger capital gains tax in respect of the distribution to Parent Company by virtue of the section 47 liquidation rollover provisions.

2017 TLAB: The intra-group liquidation appears to trigger paragraph 43A because the liquidation itself is a disposal event. In effect, each shareholder of Real Estate Subsidiary is "disposing of shares in another company", and there is an "exempt dividend received by or accrued to that company [is] in respect of the share disposed of". The dividend will be "extraordinary" because the full value of the shares are fully distributed in the liquidation.

Example: Double distributions

Facts: Listed Company owns all the shares of Sub 1, Sub 1 owns all the shares of Sub 2, and Sub 2 also owns all the shares of Sub 3. Sub 2 distributes Sub 3 to Sub 1, and Sub 1 also distributes the shares of Sub 3 to Listed Company.

Outcome:

Pre-2017 TLAB: The intra-group distributions would both be tax-free unbundlings under section 46.

2017 TLAB: The second unbundling of Sub 3 (by Sub 1) appears to trigger capital gains under paragraph 43A. In effect, Sub 1 is "disposing of shares in another company" (i.e. Sub 3), and there is an "exempt dividend received by or accrued to that [Sub 1] company [that is] in respect of the share disposed of". The dividend will be "extraordinary" because the full value of the Sub 3 shares are fully distributed. Note: If Listed Company subsequently distributes Sub 3 again, the subsequent distribution should be tax-free under section 46 but may be undone by paragraph 43A if distributed to a listed company shareholder.

5. Significant addition in TLAB - debt benefit triggered by a change in any term or condition of a debt (as part of proposed substitution of section 19 and paragraph 12A of the Income Tax Act)

A significant additional trigger for a debt benefit, that was not in the draft TLAB, has been added in the TLAB that was tabled. This addition means that a change "in any term or condition" of a debt would require the amount of the debt benefit to be quantified and to be subjected to the tax consequences flowing from a concession or compromise of a debt. For example, if a subsidiary has a loan from its holding company, and the holding company (even temporarily) subordinates the loan in favour of the subsidiary's creditors to restore the subsidiary to solvency so that it can retain its going concern status (for audit and other purposes), the subsidiary is likely to suffer these tax consequences. There is also no group exemption in relation to this trigger.

This additional trigger was proposed and consulted on by National Treasury at a public workshop held on 26 September 2017. The proposal was generally met with concern. SAIT and SAICA thereafter made a joint submission to National Treasury to present concerns discussed by participants from various accounting and law firms at a subsequent meeting of such participants held on 2 October 2017 in relation to the new proposal: Collaborative submission by SAICA and SAIT on the revision of debt reduction proposals in Draft 2017 Taxation Laws Amendment Bill – significant new addition: debt benefit triggered by change in any term or condition of a debt

As set out in the joint submission, we have various reservations, in principle, regarding the proposal which triggers tax consequences even if the amount of the debt remains outstanding and unchanged. We are also concerned that there has not been adequate opportunity to consider the potential consequences of this trigger and for public engagement thereon. Bringing this proposal into operation from 1 January 2018 (years of assessment commencing on or after that date) with possible amendments in subsequent legislative cycles, would mean that taxpayers would operate in an environment of uncertainty and may give rise to a minefield of unintended consequences.

We note that the proposed wording contained in the TLAB in this regard, is not clear. An updated draft explanatory memorandum on the TLAB has not been published so taxpayers do not have guidance on the interpretation. We question whether the design and drafting of this proposal has been adequately thought through. For example:

- There is no mechanism to take into account previous debt benefits. Therefore, it is possible that a debt benefit could be doubled-up when, say, a debt is first changed from interest-bearing to interest-free and then later totally waived.
- There is no mechanism to reverse the tax consequences of a debt benefit if the relief provided by the creditor is subsequently removed, for example when a holding company no longer subordinates its loan to its subsidiary (e.g. after the subsidiary becomes solvent).
- Based on the drafting, it appears that a change in the interest rate will trigger a debt benefit, even though we understood in the workshop that this would not be the case.
- Certain debts which are treated as equity for tax purposes to prevent tax-avoidance will, anomalously, also suffer debt benefit consequences.

We strongly recommend that the proposal that the change of terms or conditions of a loan would trigger a debt benefit should not be proceeded with (or at least delayed until 2019). We suggest that, if National Treasury wishes to proceed with this proposal, adequate consultation should take place in a future full legislative cycle, as the consequences of such a change are likely to be significant and cannot all be foreseen and considered at this stage.

We appreciate the opportunity for engagement throughout the legislative process and would like to reiterate our willingness to assist in ensuring that the proposals achieve their desired objectives.

Yours sincerely

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