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RE: DRAFT TAXATION LAWS AMENDMENT BILL (TLAB), 2017: COMMENTS PERTAINING TO KEY INTERNATIONAL TAX ISSUES

We have attached the comments from the SAIT International Tax Work Group on the draft Taxation Laws Amendment Bill pertaining to key international tax issues. We also comment on certain key business tax issues which have a cross-border impact. 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

Anne Casey
Chair of the International Tax Work Group

1. Section 9D: Extending the application of the CFC rules to foreign subsidiaries held by foreign trusts and foundations within an IFRS 10 Group

1.1 Proposed amendment

The proposed amendment seeks to overcome the use of foreign trusts and foundations as a means for artificially breaking the CFC status in relation to a foreign entity. In effect, the rules treat foreign subsidiaries as CFCs if those foreign subsidiaries would be part of a consolidated set of financial statements under IFRS 10. The tainted income of these foreign subsidiaries is allocable to *"the holding company, as defined in the Companies Act, that is a resident*".

1.2 Problem identified

We fully understand the desire for National Treasury to pull foreign subsidiaries held through foreign trusts / foundations into the CFC net. We presume the situation of concern is where a South African parent company with multiple South African subsidiaries holds multiple foreign subsidiaries through a discretionary foreign trust / foundation. The discretionary nature of the foreign trust / foreign foundation allows for vesting to any one of the South African group members while leaving the economic group in effective control of all foreign subsidiary income. This discretion can technically be used to undermine the CFC regime for all South African multinational groups.

The problem with IFRS 10 is that consolidation is also very open-ended depending on the facts and circumstances. IFRS 10 technically requires an investor to consolidate in its financial statements in respect of any investee when the following attributes apply to the investor, namely:

- Power over the investee,
- Exposure or rights to variable returns to its involvement in the investee,
- The ability to use its power over the investee to effect the amount of the investors returns.

It also provides guidance on different situations, for example having power without having the majority voting rights i.e. de facto power or potential voting rights or agency relationships or relationships within entities designed so that voting rights are not a dominant factor to show control.

Given the above, the main difficulty with the IFRS 10 allocation lies in the precision needed for the section 9D(2) income allocation. The consolidation of the foreign company's financial results as determined under IFRS 10 can easily become a clumsy method of determining the pro rata percentage participation rights held by a resident company as there are many variables involved in determining control under the IFRS 10 statement.

Furthermore, it is noted that IFRS 10 has a particular focus on the investment management industry, which does not translate neatly to the CFC legislation. It is also noted that IFRS 10 provides guidelines on how applicable consolidated financial statements should be prepared, but this does not always result in a set percentage of the financial results – the key variable required for a section 9D(2) proportional income allocation.

1.3 Suggested solution

While we understand the desire to rely on IFRS 10 given that the main structure of concern should fall into IFRS 10, we wonder whether the impact will be as successful for SARS as intended. In essence, what SARS really needs is a test for practical control via commercial law concepts. The determination should be limited to a factual test of a right or entitlement to receive income from the underlying foreign company.

If the link to IFRS 10 is indeed maintained, we recommend that greater clarity be introduced around what percentage participation rights are to be assumed for the application of the proposed proviso.

2. Section 25BC: Taxing distributions received by SA resident beneficiaries from foreign trusts and foundations

2.1 Proposed amendment

A new section 25BC is proposed to be introduced which will tax as ordinary income any distribution received by a South African resident beneficiary (other than a company) from a non-resident trust or foreign foundation. The proposed section 25BC will apply where a non-resident trust or foreign foundation holds a participation right in a foreign company and that foreign company would have constituted a CFC if the trust or foundation had been a resident (i.e. where the foreign company is more than 50 per cent held by the foreign trust / foundation).

2.2 Policy concerns

The proposed amendment runs contrary to longstanding South African tax policy. The proposal effectively punishes South African taxpayers when they repatriate funds back to South African. This tax upon repatriation will simply mean that funds will not return unless the taxpayers at issue are in dire need of funds without other options.

The participation exemption of section 10B specifically recognises the need to exempt funds upon repatriation (along with the Exchange Control credit). This exemption stems from Europe and remains in place even after the OECD pronouncements of Base Erosion and Profit Shifting. We note that the United States is one of the few countries that seeks to tax CFCs when repatriating funds back home via dividends, and this tax on repatriation is often slated as one of the main reasons that United States companies have left so much excess funds offshore (as opposed to return and reinvestment in the United States).

We also question why section 25BC is required if the proposed changes to section 9D create the required level of section 9D(2) income. If the foreign subsidiaries of a foreign trust / company structure fall under section 9D, why should there by a reason to tax the repatriation again? The goal has always been to tax the offending income offshore as that CFC income arises as opposed to repatriation charge that hinders the return of funds back to South Africa.

2.3 Process concerns

Proposed section 25BC goes far beyond group structures in which foreign subsidiaries are held through foreign trusts and foundations. The proposed change also seems to be directly aimed at family wealth held through foreign trusts. This is a big change that was not explicitly raised in the 2017 Budget Review. It appeared to the common eye that changes to “interposed trusts” were mainly aimed at the group structures outline above (not family trusts).

Despite the Davis tax committee statements that further taxes should fall on the wealthy, we question the wisdom of hitting wealthy South African families hard when their “foot” is already halfway out the door. A large tax increase in their offshore repatriations could easily lead to further emigration in the current economic climate. While National Treasury and SARS may take comfort in the existence of the section 9H exit charge, we note that this charge would not apply to holdings currently held through a foreign trust / foundation. A new charge of 45 per cent on offshore repatriations may easily become the tipping point, especially for retired South Africans who are heavily relying on these structures as a major source of their retirement funding.

2.4 Technical problems identified

Proposed section 25BC could easily be viewed as onerous. In effect, if a foreign trust / foundation holds a foreign subsidiary, all dividends from that subsidiary will be subject to normal tax rates of 45 per cent. The participation exemption of section 10B no longer applies (nor does the capital gain exemption of paragraph 64B if those funds are received or accrued to a foreign trust / foundation beneficiary).

Moreover, the mere existence of a more than 50 per cent subsidiary taints everything else held by the trust. All other income or capital gains will be pulled into the 45 per cent net.

Lastly, we wonder how section 25BC will interact with the vesting rules of section 25B. It would appear that section 25B could apply to trigger tax first, followed by section 25BC. Both charges must take cognizance of one another to eliminate the problem of double taxation.

2.5 Suggested solution

We think that section 25BC is overly complicated and excessive. If Government does indeed want to tax dividends from foreign companies held through foreign trusts, we believe a far simpler mechanism is possible.

We would instead suggest that foreign companies held through foreign trusts lose the benefit of the foreign dividend and capital gain participation exemptions (of section 10B and paragraph 64B of the 8th Schedule). Indeed, some would argue that these provisions already do not apply when shares are held through discretionary trusts. Under this approach, foreign dividends purchased through foreign trusts would be subject to a 20 per cent charge (and capital gains on the shares would be subject to an effective 22.4 per cent charge). Other amounts within the foreign trust / foundation would be wholly unaffected. This approach would at least be viewed as far more reasonable the new 45 per cent charge outlined above.

3. Section 8G: Determination of contributed tax capital in respect of shares issued to a group company

3.1 Summary:

In terms of the Explanatory Memorandum, the proposed amendment is intended to limit the amount of CTC in two targeted scenarios; (i) in the case of a share repurchase (buyer subscribes for shares and the target uses the consideration to buy back its shares from existing shareholder), and (ii) where an intermediary holding company is interposed between the original foreign shareholder and the Target South African company.

However, in terms of the actual wording of section 8G, the section applies in two scenarios:

3.2 Scenario 1:

a company (Intermediary) issues shares to a Subscribing company (Foreign Parent) and the consideration for those shares consist of shares in another company (Target). The Intermediary and the Subscribing company needs to form part of the same group of companies after the issue of shares. Furthermore, the Target should form part of the same group of companies as "those companies". The reference to those companies is to the Subscribing Company and the Intermediary.

3.3 Scenario 2:

a company (Target) issues shares to a Subscribing company (Buyer) and the consideration for those shares is used by the Target to directly or indirectly acquire "any shares in another company" (Seller). The Target and the Subscribing Company need to form part of the same group of companies after the issue of shares. Furthermore, the Seller needs to form part of the same group of companies as "those companies". The reference to those companies is to the Subscribing Company and the Target.

Scenario 2 problem statements:

3.4 Problem statement 1:

How does a Target acquire shares "in" the Seller if this provision is intended to target share buy backs? Surely the Target should be buying back its shares from the Seller.

3.5 Problem statement 2:

It is not clear whether the Seller needs to be in a group relationship with both the Subscribing company and the Target or whether the Seller simply needs to be in a group relationship with either the Subscribing Company or the Target.

3.6 Problem statement 3:

When do we measure the group relationship between the Seller and either or both the Subscribing company and the Target? Is it before or after the buy back? If it is after the buy back, surely the Seller would have exited and can never fall within a group relationship with the Target.

If it is before the buy back, then there is an even much bigger problem. The Seller and the Subscribing Company are unlikely to form part of the same group of companies. Both are shareholders in the Target.

3.7 Problem statement 4:

If the group relationship between the Target, Seller and Subscribing Company is measured after the acquisition, then the scope of the amendment is too wide to cover ordinary acquisition transactions where a special purpose vehicle, BidCo is used to raise capital and ring-fence the acquisition. The acquisition may or may not involve a share repurchase, but will be covered by the provision on the basis that Bidco is capitalised (issue shares) and the consideration is used to acquire shares in another company (Target Company).

Scenario 1 problem statement:

3.8 Problem statement 5:

It is not clear how the CTC limitation reads with the definition of CTC in the circumstances where the Intermediary Company is a non-resident that becomes a resident following the acquisition of the Target. In such instance, does the Intermediary get market value CTC in terms of the definition of CTC in section 1 or is the CTC limited in terms of section 8G. Surely the scope of section 8G may not be extended to a foreign Intermediary company. There may also be valid commercial reasons for this foreign company to invert to SA. In fact, from the Domestic Treasury management company dispensation amendments, it appears that Treasury wishes to encourage foreign companies to relocate to SA without changing their place of incorporation.

Determining the limited CTC

3.9 Problem statement 6:

In re the wording of the proposed paragraph (b) of subsection (3) of section 8G. Paragraph (b) refers to the "…other company" forming "…part of the same group of companies…". The paragraph further provides refers to "…that subscribing company…". Applied to the scenarios highlighted in the above, the "other company" should be the Target Company in scenario 1 or the Seller in the case of scenario 2.

At issue is that it is not clear in relation to whom the Intermediary or Target should form part of the same group of companies. Does the reference to "irrespective of whether that subscribing company formed part of that group on that date" mean that implicitly, the group referred to is the group between the Intermediary and The Target (in the case of scenario 1) and the Target and the Seller (in the case of scenario 2)? If this is the case, we request that this should be clarified in the legislation without the proposed prolix that is so difficult to manage.

It must be noted that in this case, the Target and the Intermediary will probably be a group of companies on the date that the Subscribing Company subscribes for shares in the Intermediary in the case of scenario 1. On the other hand, in relation to scenario 2, the Target and the Seller may have been a group of companies all along, until the date of the share buyback or dilution upon the new subscription by the subscription company. The point in time at which the Target and the Seller's group status is measured seems to be the original date on which these companies started to form part of the same group. The CTC at the original group date may be different (increased or decreased) from that time to the time that the dilution or buy back takes place. Shouldn't the measure rather be on the date before the exit?

3.10 Proposed solution:

The aforementioned are significant problems covering both the conceptualisation of the section and technical arrangement of the wording of the section. It is, in our view, unfortunate that a section that is so poorly organised and conceptualised may be brought into effect retrospectively. We thus propose that the section be deferred to the 2018 legislative cycle for further consideration of the impact and refinement so that it can be more targeted to transactions of concern.

4. Tax treatment of conversion of debt into equity and artificial repayment of debt (section 19A)

4.1 Proposed amendment

The introduction of section 19A is to provide for specific rules dealing with the conversion of debt to equity and to address the abuse associated with certain debt structures.

The rules will apply to multinational groups of companies, however, as an anti-avoidance measure, interest which is allowable as a deduction will be recouped if such interest is not subject to normal tax in the hands of the creditor. A further anti-avoidance measure has been introduced in the form of a de-grouping clause where, if the companies cease to form part of the same group of companies during any year of assessment, the remaining amount of recoupable interest (as defined) will be recovered in that year of assessment.

We note that three sets of rules will now apply to cross-border interest, namely thin capitalisation/transfer pricing; section 23M and this proposed rule. Most of the world just relies on thin capitalisation with a few countries relying on an EBITDA type rule such as section 23M. It seems that South Africa is now going way beyond this. If the new rule is to be implemented, its application should be limited to be reasonable. We have made suggestions in this regard under point 4.3 below.

4.2 Problem identified

The requirement that the interest income must have been subject to **normal tax** means resident debtor companies funded by non-resident companies forming part of the same group companies will be subject to the provisions of 19A(2).

We note that interest payable to a non-resident will be subject to interest withholding tax. However, this withholding tax does not fall within the definition of normal tax. Accordingly, non-resident group companies will be prejudiced in this regard.

We further note that the intention is to allow for the recoupable interest to be set off against the amount of any assessed loss or balance of assessed loss of that company. Where a company is in distress, it will typically have ceased to carry on a trade as required in section 20(1) of the Income Tax Act. On this basis, the company will not be in a position to utilise the assessed loss or balance of the assessed loss to shield a portion of the recoupable interest. This unfairly prejudices companies which have ceased to trade.

Finally, with regard to section 19A(3), the remaining amount of recoupable interest will be recovered should the companies cease to form part of the same group of companies. This may apply in instances where a company is liquidated, wound up or deregistered. This could not have been the intention of the legislature as the very point of allowing for a conversion of debt to equity without adverse tax consequences is to avoid instances of SARS or liquidators having to account for tax on income which has been recouped in terms of section 19 or paragraph 12A of the Eighth schedule.

4.3 Suggested solution

We recommend the same wording as provided for in section 23M is used. Consequently, “normal tax” should be replaced with the phrase “**subject to tax**”.

We further suggest that the "carrying on a trade" requirement as set out in section 20 of the Act is removed for purposes of section 19A. In other words, the assessed loss should be available as a shield regardless of whether or not a trade has been carried on.

Finally, we recommend similar wording to that set out in section 45(4)(c) is provided for to cater for relief in a liquidation, deregistration of winding-up scenario.

5. Recoupment in respect of intra-group debt exchanged for or converted to shares (section 19B)

5.1 Proposed amendment

An additional anti-avoidance provision is contained in section 19B to deal with situations where companies cease to form part of the same group of companies within the 5 year prescribed period. Should this occur, an amount equal to the difference between the face value of the debt and the market value (determined at the time of the de-grouping) of the shares issued by the debtor as consideration for the reduction or settlement of the debt will be recouped in terms of section 8(4)(a) of the Act and subject to tax in the debtor's hands during the year of assessment the companies ceased to form part of the same group of companies. The deemed reduction amount will be reduced by any interest recouped in terms of section 19A.

5.2 Problem identified

Where a company is in distress, the value of the shares issued may continue to decrease after the conversion of any debt to equity and may therefore be less than the face value of the debt at the time of de-grouping. The linking of the face value of the debt to the market value of the shares at the time of de-grouping will therefore lead to unpredictable and prejudicial results for companies in distress.

The de-grouping period of 6 years is also too long and not commercial in a group company scenario where the intention is to eliminate distressed or dormant companies.

As with section 19A, a liquidation, deregistration or winding up of a company will trigger a de-grouping. This cannot be the intention of the legislature

5.3 Suggested solution

We suggest the de-grouping period should be fixed at 18 months to allow for a more expedient approach to dealing with distressed companies.
We also suggest that the market value of the shares be fixed to that at the time of the conversion of the debt and not at the time of de-grouping.

We further recommend similar wording to that set out in section 45(4)(c) is provided for to cater for relief in a liquidation, deregistration of winding-up scenario.

6. Addressing the tax treatment of debt forgone for dormant group companies (section 19 and paragraph 12A of the Eight Schedule)

6.1 Proposed amendment

In response to the request for the relief currently provided for in paragraph 12A(6)(d) to be included in section 19 on the same basis, it is proposed that the current paragraph 12A(6)(d) dealing with the exemption in respect of debt which has been cancelled, waived, forgiven or discharged within a group of companies as defined in section 41 should be replaced with a more targeted exclusion.

It is proposed that:

a) The paragraph 12A(6)(d) group exemption will be extended to apply to section 19; and
b) Paragraph 12A(6)(d) of the Eighth Schedule, which makes provision for group exemption in respect of debt that is reduced, cancelled, waived, forgiven or discharged between South African groups companies will be limited to apply only to instances where the debtor is a dormant company within a group of companies as defined in section 41 of the Act.

6.2 Problem identified

The Explanatory Memorandum makes specific reference to the relief in terms of the amended paragraph 12A(6) of the Eighth Schedule and new section 19(8)(d) being intended to allow resident groups of companies to eliminate dormant companies and debt without any tax impediment.

However, instead of extending the current relief provided in paragraph 12A(6)(d) to section 19, SARS has narrowed the group relief available in paragraph 12A(6)(d) by including a dormancy requirement.

For purposes of this exclusion, a company will only be regarded as being dormant if the company meets the following requirements during the year of assessment in which the debt is reduced, cancelled, waived, forgiven or discharged and the preceding three years of assessment:

- the company has not traded;
- no amounts have been received or accrued to the company;
- no assets have been transferred to or from the company; and
- no liability must have been incurred or assumed by the company.

It is not feasible to require a company not to have incurred or assumed any liability during the year of assessment and preceding 3 years in order to qualify for the intended relief. For example, statutory fees and other fees such as CIPC fees will be incurred on an annual basis. It will therefore not be possible to meet the dormancy requirements. The intended period of dormancy, being 3 years including the year of assessment in which the reduction occurs is also too long and not commercial in the current economic environment.

Furthermore, as the intended amendment to section 19 and 12A(6)(b) does not extend to CFCs (given that they would not be part of the section 41 group), resident group companies with CFCs cannot eliminate non-performing CFCs and debt advanced by resident companies to CFCs without triggering a recoupment in accordance with the provisions of section 9D of the Income Tax Act. This would mean that a recoupment would be triggered and imputed into the South African group company without any relief.

6.3 *Suggested Solution*

We recommend that paragraph 12A(6)(d) remains unchanged and that the provisions of the existing paragraph are included in section 19.

If the intention is to require some level of dormancy, we suggest it would be a more reasonable to limit the requirements to the following:

(i) That the company has not carried on any trade;

(ii) No amounts have been received by or accrued to the company

(iii) No assets have been transferred to or from the company

The stated period should be reduced to 18 months to be consistent with other time periods specified in the Act and taking into account the intended relief.

We further request that the following amendment is proposed:

(iv) That company owes debt to a company that forms part of the same group of companies as defined in *section 1* as that company.

7. Section 22B and paragraph 43A: Share buy backs and dividend stripping

7.1 *Problem statement 1:*

The revised qualifying interest moves away from prescribing a pre-funding requirement for the affected dividends. This creates a problem as it effectively moves away from a criterium that specifically targeted the perceived tax avoidance transactions. This has the effect that even ordinary dividends declared out of reserves of the company are caught; a position that was previously rejected by industry and to which National Treasury conceded back in 2009. There is no reason whatsoever for legislation to lock-in existing reserves or embedded gains in the company simply because the owners envisage a disposal. The mere declaration of those reserves should not in the absence of any other tax avoidance indication (e.g. where the dividends are funded out of proceeds of subscription by another party) be deemed to be motivated by tax avoidance.

7.2 *Proposed solution 1:*

The pre-funding requirement should be maintained and, if required, this should be extended to include equity prefunding as was always the intention outlined in the 2009 Explanatory Memorandum to paragraph 43A and 22B.

Rather than covering normal disposals, it seems the target transactions are share buy backs. The wording covering share buy backs is used in paragraph 19 of the Eighth Schedule. Rather than covering any outright disposal, we propose that the specific wording targeted at share buy backs as used in paragraph 19 should be used.

7.3 *Problem statement 2:*

The extension of the coverage of the section to minority interests (i.e. 20 percent equity shares and voting rights is unfortunate in the context of a 20 percent shareholding where the other shareholding (i.e. majority shareholding) is spread amongst connected parties. The reference to “no other person” in paragraph (b) of the definition of a qualifying interest seems to suggest that only a single shareholder majority can exclude the coverage of a 20 percent stake. BEE shareholding is often in the region of 25 percent equity and voting rights. These shareholders are however more likely not in control of the mechanics of exiting or refinancing the investment; alternatively, may have an embedded option to sell their shareholding or part of it to the Target company.

7.4 *Proposed solution 2:*

The participation threshold for covered transactions should be limited to the 50 percent equity or voting rights. Alternatively, we propose that the majority equity shares or voting rights carve out in paragraph (b) of the definition of qualifying interest should be extended to include connected parties.

Consideration could also be given to exclude shares with embedded options to sell as in the equivalent anti dividend stripping rules in paragraph 19 of the Eighth Schedule.

7.5 Problem statement 3:

The reference to a direct or indirect "interest" seems to add very little but confusion to the construct of the qualifying criteria. The essence of the definition is that there must be a 'holding', directly or indirectly, whether alone or together with any other connected person.

7.6 Proposed solution 3:

The much commonly used and known wording as in paragraph (iv) of the definition of 'connected person' could be used, rather than the reference to "interest".

8. Section 24I: Adjustments to the definition of an affected contract

8.1 Problem statement:

It appears that the adjustment to the definition of affected contract was meant to cover a scenario where the hedge instrument covers more than one hedged item, some of which may not be a qualifying debt. This scenario is described in the form of an example in the Interpretation Note on section 24I. In the relevant example, SARS provides that a "person may enter into an FEC to serve as a hedge for more than one item of debt. Some of those items of debt may not meet the requirements of an affected contract and some of the items of debt may meet the requirements of an affected contract. For example, an FEC of $200 000 is taken out to hedge debt of $150 000 for goods delivered before the end of the year of assessment and debt of $50 000 for the purchase of goods which will be delivered in the following year of assessment. The FEC will be an affected contract to the extent of $50 000."

Whilst the proposition may be understandable, we believe that the use of the words "to the extent" in the revised definition may not necessarily meet this goal. At issue is whether the proposed wording refers to the effective portion and ineffective portion of the hedge or simply the situation as described by SARS in the Interpretation Note. It would be more helpful to be more specific. Arguably, the bifurcation of the hedge instrument in respect of qualifying and non-qualifying hedged items is already covered by the existing definition; which makes the change superfluous and adding uncertainty to the section rather than providing clarity.