

19 January 2017

The Davis Tax Committee  
Hatfield Gardens (Block A)  
333 Grosvenor Street  
Hatfield, Pretoria 0083

BY EMAIL: [taxcom@sars.gov.za](mailto:taxcom@sars.gov.za)

**RE: CORPORATE TAX REFORM ISSUES: INITIAL COMMENTS**

Dear Davis Tax Committee

This submission acts as an initial response to the committee's calls for comments regarding the potential need to reform of South African tax system in terms of company tax issues. The purpose of this initial submission is to highlight the recurring main themes of debate without passing on the merits. Further commentary can be added where the committee indicates viable interest.

**1. Balance between company dividends and deductible payments (e.g. interest and services) to shareholders**

*A. Dividend payments to individuals*

A classic issue in the corporate tax arena is the distinction between dividends and other extractive payments. In the case of dividends, the paying company incurs no deductions; whereas, other payments like interest and services are deductible. At issue is whether these differences can be exploited to create unintended incentives in respect of certain payments to shareholders over others.

-2-

Example:

*Facts:* A single individual owns all of the shares of Company X. Company X earns R500 000 of taxable income for the year and seeks to pay the full R500 000 to the individual (whose top marginal bracket is 41 per cent).

*Outcome:*

- **Dividends:** If the company pays the amount as a dividend, the full R500 000 is subject to a 28 per cent rate (with the dividend being non-deductible). Of the R360 000 remainder (R500000 – R140000), the R360 000 is taxable at 15 per cent when paid to the individual (i.e. R54 000). Total net taxes paid equal R194 000 on the R500 000 net profit that the company earned (a 38,8% effective tax rate).
- **Deductible Payments (Services/Interest):** If the company pays interest/service fees instead, all payments are deductible, thereby reducing the company taxable income to zero. Individual pays 41 per cent on the full R500 000 received, resulting in taxes payable of R205 000 (a 41% effective tax rate).

Hence, in a domestic context, dividend payments to individuals result in slightly reduced taxes, meaning that a slight incentive exists to pay dividends over services / interest. The net result is the combined company tax / shareholder tax that is less than the top marginal individual rate. This is an unusual feature of the South African tax system (countries like the United States have the reverse problem with dividends having a distinct disadvantage over deductible interest / dividends). The net result may be a slight incentive to keep funds within a company, especially if dividends are deferred (thereby delaying the 15 per cent charge).

*B. Dividend payment to companies*

It should be noted that the South African tax system follows a classical system for company-to-company dividends. Dividends to company shareholders are simply exempt in order to prevent multiple taxes falling on the same underlying earnings.

Example:

*Facts:*

Individual owns all of the shares of Holdco, which in turn owns all the shares of Operating Company. Operating Company earns R500 000.

*Outcome:*

- Dividends: If dividends are paid from Operating Company to Holdco, the dividends are fully exempt. Operating Company is subject to tax on the full amount of R500 000. Holdco is fully exempt. If Holdco pays dividends to Individual, the second round of dividends are subject to tax at 15 per cent. (If dividends were taxed when paid to Holdco, the underlying R500 000 amount would be subject to two levels of dividends tax in respect of the same underlying Operating Company dividends.)
- Deductible Payments (Services/Interest): If deductible interest / service payments are made by Operating Company to Holdco, the net R500 000 taxable income shifts from Operating Company to Holdco. The tax system is generally neutral because both entities are subject to the same 28 per cent rate.

As a general matter, dividends versus deductible interest / services has no net impact on the tax system because companies all have the same rate. In a few cases, the Operating Company may have an incentive to pay interest / services over dividends if the Holdco has excess assessed loss carryovers. (On the other hand, if Operating Company has excess losses, dividends are preferred because net income can be absorbed by the losses at the operating company level.)

## 2. Dividends versus capital distributions

### A. *Impact of distinction*

Dividends theoretically represent the corporate payment of profits; whereas, capital distributions theoretically represent return of initial capital paid by the shareholders into the company (usually when formed). The tax consequences of each type of payment differ.

- As stated above, dividends paid to individuals trigger a 15 per cent charge. Dividends paid to companies are wholly exempt.
- Capital distributions can either result in no tax or capital gain. Capital distributions reduce the base cost in shares; once the base cost in the shares are reduced to nil, further capital distributions trigger capital gain. The result is the same regardless of whether the shareholder is an individual versus a company.

#### Example:

Individual owns shares with a base cost of R80. If Individual receives a capital distribution of R90, the base cost in the shares is reduced to zero with additional R10 of capital gain.

Individual shareholders generally prefer capital distributions over dividends because the reduction of base cost in shares is preferred over an immediate 15 per cent dividends tax. Once base cost is gone, individual shareholders are largely indifferent because the capital gains charge is 16.4 percent versus the dividend tax of 15 per cent.

Company shareholders absolutely prefer dividends because company-to-company dividends are exempt. Capital distributions reduce base cost and /or trigger immediate capital gain.

*B. Tax legal distinction*

The current tax distinction between dividends versus capital distributions is almost wholly elective. If no taxpayer election is made, all distributions are treated as dividends. Taxpayer may alternatively seek to withdraw capital distributions to the extent tax capital was previously contributed to the company. Tax capital equals the total cash / assets contributed to the company in exchange for shares issued by that company in exchange for shares.

The regime is wholly elective because the concept of share capital/ share premium no longer exists in company law. In terms of company law, all distributions in respect of shares are simply viewed as distributions (not dividends nor capital distributions). Under current company law, companies simply cannot make distributions if the distribution triggers asset or liquidity insolvency. Under old law, the parties could freely choose to extract profits (as dividends) or A return of capital (as a capital distributions) to the extent profits or capital was available.

One problem under current tax law is the ability to extract total value from a company as dividends when the sums of the company solely arose as capital contributions (or as borrowings). Company shareholders have a tendency to choose dividends (despite the lack of profits) because company-to-company dividends are wholly tax-free. Query whether this ability to choose dividends should continue when profits of the paying company are insufficient.

Example:

Company X contributes R5 million to a wholly owned subsidiary. The subsidiary generates profits of R1 million. If Company wants to withdraw the full R6 million, the full amount is a tax-free dividend if no election is made. However, only R1 million should be a dividend and the other R5 million should be capital distributions as an economic matter (with the latter reducing the initial base cost R5 million in the shares to zero).

### 3. Companies and capital gains tax

The United States and many OECD countries impose the same rate of tax on corporate capital gains and ordinary revenue (except corporate capital losses are ring-fenced against corporate capital gains). The argument is that all company transactions are business / trading in nature so no capital gains distinction can be justified. At issue is whether this approach should be adopted in South Africa. One argument against this approach is the high-level of inflation in South Africa versus the level of inflation in the United States and most OECD countries.

As a practical matter, active operating companies have three general sources of capital gain: (i) capital gain from working capital (e.g. gain on portfolio financial instruments used as working capital), (ii) land/buildings, and (iii) subsidiary shares.

- Taxing gain on portfolio financial instruments (listed debt and shares) at ordinary rates is the easiest to justify because working capital is largely short-term in nature. In a listed environment, passive investments are best held in shareholder hands or through special investment vehicles (e.g. collective investment schemes). Indeed, listed shareholders commercially resist excess cash holdings left unused in corporate hands unless that excess is used for immediate corporate reinvestment.
- Companies often have gain on the sale of land or on the sale of highly appreciated buildings (after recoupments are taken into account). For example, if a company purchases a building for R3 million, depreciates the building under section 13quin for R500 000 and sells the building for R4.2 million several years later, the company has R500 000 of section 8(4) recoupment and R1.2 million of capital gain. The increased value is probably due mainly to inflation in real estate prices. Query whether this gain should be taxed in full. On the other hand, land investments do not lie at the heart of the business unless the sale proceeds are used to reinvest in new or further business

operations (in which case, maybe roll-over treatment is preferred). (Note: Reinvestment rollover rules exist for movable assets but not for buildings and land.)

- The last category of capital gain involves subsidiary shares. Some argue that this form of share gains should be left untaxed because capital gains in these cases really represent future dividends (and company-to-company dividends are free from tax). For example, assume Company X owns all the shares of a subsidiary. Company X has a base cost of R1 million in the subsidiary shares, and the subsidiary has a value of R5 million due to the build-up of cash profits within the subsidiary. A R4 million dividend is tax-free but a sale of the shares (representing R4 million of undistributed profits) generates R4 million of capital gains. If one believes that capital gains really represent undistributed dividends, these gains should be similarly exempt.

One often overlooked issue is how corporate capital gains tax rates compare to individual capital gains tax rates when the double tax system is taken into account. The corporate capital gains tax rate of 22.4 per cent is fairly high once combined with the dividend tax rate of 15 per cent. This combined rate greatly exceeds the individual capital gains rate of 16.4 per cent.

As a matter of parity, combined corporate rates and the individual rate should be roughly equal (like the system of ordinary rates). Hence, it has been suggested that parity would require a reduction in the corporate capital gains tax rate. On the other hand, the high combined capital gains tax rate for companies offsets some of the benefits of the slightly lower combined corporate rates for ordinary revenue (especially given the ability to defer the dividends tax).

It should be noted that the combined corporate capital rates overall have the effect of deterring the use of owner-managed companies as passive investment entities. If an individual chooses to invest in shares, bonds, real estate and derivatives, the choice of direct ownership versus ownership through a company is a complex one. If the investments mainly yield ordinary revenue, the company entity offers a slight advantage. On the other hand, combined corporate capital gains taxes system works

strongly against company entities in terms of passive investments (especially land). Rules previously existed to prevent “passive holding companies” (former section 9E) out of fear that the slightly reduced ordinary rates for companies (and the exemption for company-to-company dividends) would artificially result in passive holding companies. In view of the higher combined capital gains tax rate however, this concern appears misplaced.

#### **4. Group company taxation**

##### *A. Large companies*

Many listed (and other widely held) companies often have multiple subsidiaries. This separation of a large group into multiple company entities is designed mainly to separate risks and to segment management. This separation is not driven by tax. The business concern for larger South African groups is that the group operates as a single economic unit yet but the tax system treats the group in a fragmented way.

As a general tax matter, each company within the group is treated as a fully independent taxable person. Each transaction is viewed as an isolated taxable event in the main with a few deviations:

- Assets can be transferred amongst group companies with gains and losses deferred until the assets leave the group (section 45);
- Cash dividends within a group are tax-free (section 64E);
- Group transactions may be subject to certain anti-avoidance rules in terms of transactions between connected persons (e.g. the clogging of capital losses made between connected persons).

Many corporate tax specialists have requested further group company relief on the grounds that no economic gain or loss exists for transactions within the group. Gains and losses are only economically realized with parties outside the group. In more advanced tax systems, it is argued that all transactions and calculations should fall into a single scheme as if all group companies were a single company. The combined treatment of the group as a single entity is further said to benefit the revenue authority because all entities within the group would be filed as one, thereby allowing the revenue authority to review a more complete picture.

While the group tax issue has had some pull within government, the press of other work has consistently kept this issue off-the-table. One concern is complexity. Real group integration systems, like those found in Australia and the United States, are highly complex and extend to hundreds of pages. The creation of flawed rules could easily lead to avoidance, uncertainty and unfairness. Hence, two systems seem to come to the fore as reasonable / relatively simple compromises:

- i. The United Kingdom system, which allows for the aggregation of group losses against group income; and
- ii. The fiscal unity system of the Netherlands (with groups filing as one entity, much like the system for accounting).

At the end of the day, the theoretical appeal of group tax is to improve the match between taxable income and accounting income (the latter of which is fully determined on a consolidated basis). Further examination will be required of each system from a local country expert to properly understand the subtleties.

#### B. *Owner-controlled groups*

Many individuals (and related family members) often control a series of independent companies without the benefit of group relief. Individuals may directly own all of the shares in multiple

companies or through a unifying trust. The problem for these owner-managed groups is the failure to satisfy the group company definition because groups must be linked through a single company parent.

Many of these owner-managed groups treat all of their entities as a single economic unit, thereby giving rise to endless unintended tax difficulties. The question is whether the group definition can be adjusted to suite these scenarios.

## 5. Assessed losses and troubled companies

### A. *Assessed losses*

The South African tax system has a fairly simple set of rules for assessed losses. Assessed losses can be carried forward indefinitely. They cannot be shifted from one company to another, and income cannot be shifted into a loss company for tax avoidance purposes (see section 103(2) in terms of the anti-avoidance rule). At issue is whether all of these rules are sufficient.

- As a theoretical matter, companies involved in certain reorganisations (e.g. mergers) should qualify for the shifting of losses. For instance, if a target company merges into an acquiring company, the losses of the target company should shift to the acquiring company because the two companies become one. At present, skilled advisors can avoid this limitation by simply having the profitable company merge into the acquiring company (because pre-existing losses of the acquiring company largely remain in-tact (but for section 103(2))).
- While section 103(2) theoretically prevents transactions mainly aimed at loss trafficking, the trigger is fairly open-ended and vague. Query whether this rule is a viable threat under the existing case law and / or whether the rule creates unnecessary uncertainty for legitimate transactions. In

other words, the essential question is whether the anti-avoidance rules should be shifted from a wholly subjective approach to a more objective approach.

*B. Troubled companies*

The tax system only partially recognizes the need for relief when the debt of a company is cancelled or reduced by creditors as part of an effort to revive the company. The main set of rules associated with this relief are paragraph 12A of the 8<sup>th</sup> Schedule and section 19 of the normal tax. Paragraph 12A effectively reduces tax attributes when debt is reduced if the initial loan funds were used to invest in capital assets. Section 19 relates to ordinary asset investments. Both sets of rules allow indebted taxpayers to reduce tax attributes (e.g. losses and / or tax cost in assets) in lieu of capital / ordinary gain. In the case of capital-related debt, no further consequences exist if no capital attributes remain to soak-up cancelled capital debt. In the case of ordinary-related debt, ordinary revenue arises if no ordinary attributes remain to soak-up cancelled ordinary debt.

Mainly at issue is whether these debt cancellation rules fully work as intended. The ordinary debt cancellation rules provide far less relief than the capital debt cancellation rules. Given the new nature of both sets of rules, many anomalies need to be eliminated. Questions also exist whether these rules provide sufficient relief to revive a bankrupt company and whether a more favourable dispensation should be provided (especially for companies under formal business rescue). The winding-up of dormant companies often to clean up large groups is also hampered by this.

Another important issue is the trading limitation. If any company (including a troubled company) ceases trading, all assessed losses are eliminated. This rule appears excessive, especially when a troubled company is temporarily forced to shut-down operations by creditors (and / or government) when subsequent efforts are made to revive the troubled company.

## 6. Reorganisation relief

The company reorganization rules were enacted in 2002 and 2003, mainly to alleviate unintended hardships caused by the enactment of the capital gains tax. Several refinements have occurred since but a wholesale review is long overdue.

The complaints with the reorganization system are as follows:

- i. The wording for the rules are mechanical (as opposed to conceptual). The mechanical nature of the rules give rise to unintended difficulties, especially when the rules interact with sections outside the reorganization provisions.
- ii. The rules only easily work for simple two-step transactions. The logic of the system was to keep rollovers simple so the system could not be abused. The rules would be expanded later with experience. Yet, this expansion has never been considered since the 2002/2003 enactment.
- iii. The rules do not cater for three-way reorganisations (sometimes referred to as triangular reorganisations) but only simple combinations. In a simple reorganization, the target company merges into an acquiring company, leaving the acquiring company with the assets of both. Alternatively, the acquiring company can acquire all the shares of the target company with the target shareholders becoming the owner of some of the shares in the acquiring company. In a triangular reorganization, the acquiring company owns all the shares of a subsidiary. The target company is then merged into the subsidiary or becomes owned directly by the subsidiary. This form of reorganisation is very popular with listed companies because listed companies typically have a holding company on top with multiple subsidiaries.

- iv. The reorganization rules have a number of small anomalies that need correction. For instance, company formations become a mess when multiple assets are transferred to a new company in exchange for shares. Also the section 45 intra-group merger rules have certain anti-avoidance measures that go too far. A simple clean-up would help.

## **7. Depreciation (e.g. allowance) simplification**

The income tax act contains a myriad of depreciation rules starting with section 11(e) e.g. 12B, 12C, 12D, and 13quin. All of these rules are conceptually the same and fall into three main categories – movables, immovable and intangibles. However, all of these rules are slightly different due to different drafters from different time periods.

We would suggest that all of these rules be combined into a simple regime (with possible small variables between the main categories). The big issue is whether one can depreciate an asset and the rate of that depreciation. A secondary set of issues is what happens on disposal (recoupment (section 8(4)), losses on disposal (section 11(o) and the interaction with the capital gains regime).

## **8. Treatment of trading stock / inventory**

The sections dealing with trading stock should be reviewed given developments in accounting standards. Section 22, which deals with amounts to be taken into account in respect of the values of trading stock, is largely formula driven. Purchases and opening stock are deducted and closing stock is added back (while further adjustments may be made to net realisable value). The deduction / add back formula necessitates tax adjustments that are not always readily apparent from the annual financial statements although they often achieve the same effect. This results in additional work and complexity in the preparation, review and auditing of tax returns. It could also result in a deviation between the annual financial statements and the tax return, thereby creating opportunities for tax abuse. Consideration should be given to relying on the cost of sales taken into account in determining

the profit before tax in the audited annual financial statements for tax return purposes. It should be investigated whether GAAR and/or IFRS would give a reasonable answer. In the case of smaller companies which are not subject to audit, the question is what measures will be necessary to prevent manipulation of the annual financial statements for tax reasons.

We also note that the term “trading stock” is more expansive than traditional inventory. Occasional sales can be trading stock without being financial accounting inventory. The amount of gain / loss from these occasional sales should probably be calculated under the 8<sup>th</sup> Schedule but the gain / loss should be taxed at ordinary rates.

## 9. Three-Tier Asset Disposal System

One of the hidden complexities of the normal tax is the three-tier system of dealing with assets. Assets can be trading stock or capital and capital assets can potentially be “allowance” assets (i.e. subject to allowance write-downs). Trading stock generate ordinary gain / loss under sections 1, 11(a) and 22. Capital assets generate capital gain / loss under the 8<sup>th</sup> Schedule. Allowance assets fall under the 8<sup>th</sup> Schedule (i.e. capital gain / loss) with possible ordinary revenue for recoupments (under section 8(4)(a)) and possible ordinary loss (under section 11(o)).

This three-tier system generates numerous technical complications and makes the act very hard to read and learn. Most of the provisions are scattered. The only set of rules seeking to reconcile all three sets of assets are the reorganization rules (section 41 through 47) and few tax specialists have mastered this subset of rules.

We would accordingly suggest a uniform set of rules for all asset disposals in terms of calculating gain / loss. Deviations should only exist when determining ordinary versus capital character (with additional special gain / loss calculations for financial accounting inventory).

## 10. Section 8C share incentive schemes

Most companies provide various share and equity-like incentives for employees. Some of these schemes are for high-ranking employees while others are for rank-and-file (and many are for both). These schemes can be in relation to shares, options and / or other rights in respect of shares and can even be in the form of notional shares.

The main purpose of the law (section 8C) is to match the cash received by employees and the tax. Hence, employees are only taxed when they have free and unfettered control over the shares. The tax applies at ordinary rates because the equity incentive is effectively equivalent to additional salary. This works well for taxpayers and government. Taxpayers are only taxed when they have full control (and can sell the shares to pay the tax) and government obtains full tax value when the rights come to fruition without battles over valuation. One contentious issue is whether dividends on restricted shares should be taxed like ordinary revenue. Taxpayers argue that the dividends are independent, and Government argues that the dividends are part of the salary-equivalent benefit received.

Equity schemes area have caused consistent problems over the years. From a government perspective, the problem is a select group of managers seeking to convert ordinary revenue from these schemes into capital gains or other forms of lower-taxed amounts (e.g. dividends). This problem typically arises where smaller-owner managed companies are at stake or in the case of aggressive private equity deals. On the other hand, many share incentive structures (especially involving black economic empowerment) for the rank-and-file employees are not tax driven and are hard to unwind or change once contractually set amongst multiples employees. Treasury and SARS often attack share schemes but end up hitting the wrong target.

The bottom-line is that this area needs to be wholly reviewed from a factual perspective. Many schemes are in trusts but each trust is constructed differently. The different constructions can result in avoidance or over-taxation. The benefits stemming from these structures only arise when cash is

paid or when shares / equity instruments become freely unfettered / ready for sale for the beneficiaries. At this point, tax should arise at ordinary rates, both as remuneration in the hands of the employee and as a deduction in the hands of the employer. Schemes to reduce these rates should be stopped while additional charges should be avoided.

## **11. Cash basis of taxation for small businesses**

Many less-formal small business owners focus on cash flow rather than profits in managing their businesses. These small less-formal businesses are often not subject to audit or even prepare annual financial statements. When these businesses prepare their annual financial statements for tax return purposes, they often base their calculations on their bank statements as they do not have proper accounting systems in place to perform accrual accounting. This means that they could be at risk during a tax audit (e.g. for not having recognized the revenue from a sale or service rendered on credit). On the other hand, these businesses are unlikely to claim the benefit of all expenses incurred but not yet paid. Consideration should be given to allowing smaller, less formal businesses to use a cash basis of taxation to reduce their tax compliance burden and risk.

It should be noted that the lack of a cash-basis tax system for income tax is closely linked to the lack of a comprehensive cash-basis tax system from VAT. Many small and medium size business continue to fall under pressure under the formalities of the invoice-based VAT system. Invoices can trigger VAT many months before cash is received. The typical wait time for small businesses when waiting for payments from large companies is 90 days. Government can delay for over a year. This mismatch of invoice vis-à-vis payment creates severe hardship and often threatens business viability. We again recommend that relief currently available to unincorporated businesses should be extended to incorporated small businesses so that incorporated small business can also account for VAT on the cash basis.

-17-

We thank The Davis Tax Committee for continuing the process of dialogue and welcome the next opportunity to engage.

Yours sincerely

**Keith Engel**

**Chief Executive**