31 March 2017

The Davis Tax Committee

Hatfield Gardens (Block A)

333 Grosvenor Street

Hatfield, Pretoria 0083

BY EMAIL: taxcom@sars.gov.za

RE: CORPORATE TAX REFORM ISSUES: ADDENDUM TO INITIAL COMMENTS – TAX-TRANSPARENT VEHICLES

Dear Davis Tax Committee

This submission is an addendum to our initial response to the committee's calls for comments regarding the potential need to reform the South African tax system in terms of company tax issues. We add our comments on the need for tax-transparent vehicles to our initial submission of 19 January 2017. The purpose of these submissions 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.

Addendum: The need for tax-transparent investment vehicles to prevent double taxation

South Africa has a pressing need for tax-transparent vehicle/s for large-scale multiple private (i.e. unlisted) investments. This is needed to facilitate investments made by a group of investors into one or more operating companies by channelling their funds through an investment holding company structure. These private investment funds include infrastructure funds (e.g. energy, transport, low-income housing or health related), private equity or venture capital funds. The need for tax-transparent vehicles is especially acute in the case of funds that are fully or partially-owned by foreign investors.

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A. The problem

Investment vehicles that are not tax-transparent introduce an additional layer of tax. Direct investments involve one or two layers of tax. For instance, assume a domestic and a foreign investor equally own 50 per cent of the shares of a South African operating company (with little or no real estate). In this circumstance, the operating company is subject to corporate income tax with an additional layer of dividends tax (DT) when the company makes a distribution to its individual shareholders. The individual investors could alternatively sell their shares with the domestic investor being subject to capital gains tax and the foreign investor being free from tax.

Problems arise when a group of investors seek to invest through an investment holding company vehicle. These holding companies typically hold one or more operating companies. The holding company vehicle is needed to join the investors together and to allow for internal management of multiple independent operating companies. These operating companies are typically sold off one at a time once profits can be realised (usually after between 5 and 10 years). This additional layer created by the investment holding company makes the investment non-viable, however.

For example, assume an individual investor invests in an underlying investment through such a company vehicle and the vehicle sells the investment at a capital gain, the vehicle will suffer capital gains tax (CGT). The investor will also be subject to dividends tax (via withholding) on the distribution of the after-tax profit. Alternatively, the investor could sell its shares in the vehicle (with a domestic investor being subject to capital gains tax and a foreign investor being tax-free). In most cases, the investor chooses not to sell off, wishing only to receive the benefit of the sold underlying investment.

The comparison below demonstrates that the effective tax rate is more than doubled if an investment is made indirectly through a company that is not tax-transparent rather than directly by a domestic individual.

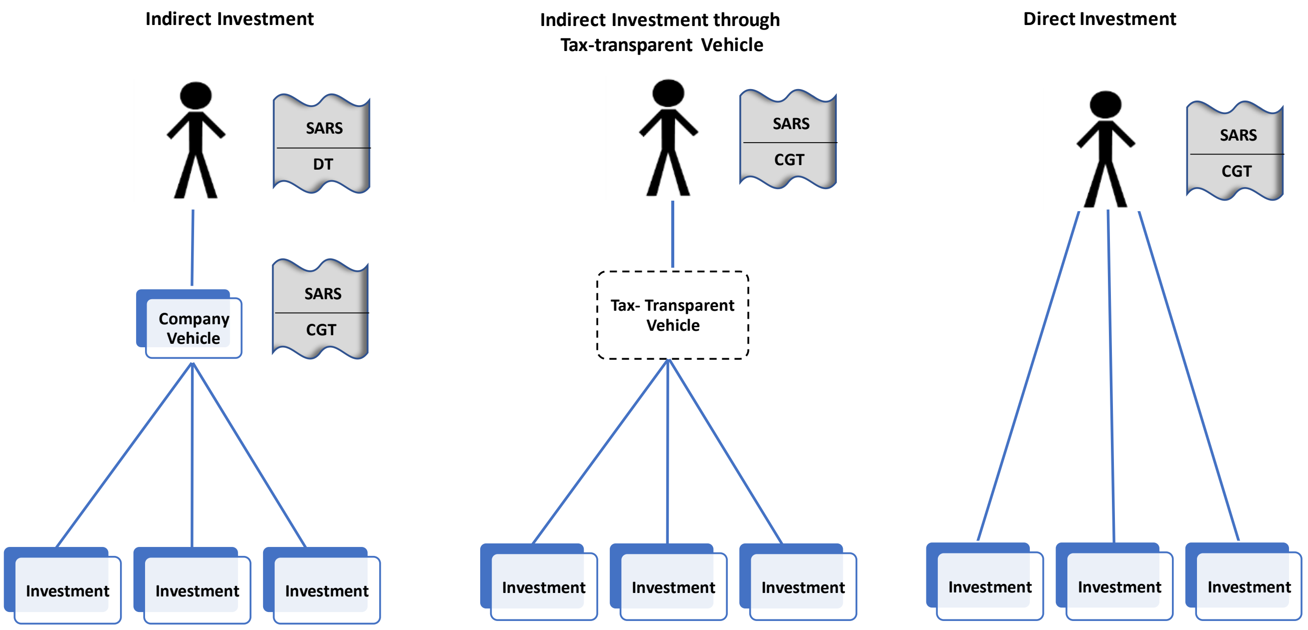
Comparison of effective tax rate of indirect investment versus direct investment	**Indirect investment**	**Direct investment**
Tax rates:		
Individual tax rate	45,00%	45,00%
Company tax rate	28,00%	28,00%
Effective CGT rate of individual (45% x 40%)	18,00%	18,00%
Effective CGT rate of company (28% x 80%)	22,40%	22,40%
Dividends tax rate	20,00%	20,00%
Assumptions/facts:		
Proceeds on disposal of underlying investment	R 250,00	R 250,00
Base cost of underling investment	-R 150,00	-R 150,00
Capital gain	R 100,00	R 100,00
Tax calculation:		
Capital gain	R 100,00	R 100,00
CGT thereon	-R 22,40	-R 18,00
After tax gain	R 77,60	R 82,00
Distribution to investor - before tax	R 77,60	
Dividends tax	-R 15,52	
Distribution to investor - after tax	R 62,08	
Total tax on gain	R 37,92	R 18,00
Effective tax rate on gain	37,92%	18,00%

South African Institute of Tax Professionals

B. Possible investment-fund type relief

Ideally an investor should be neutral for tax purposes, whether they invest directly or through an investment vehicle. This could be achieved if the investment vehicle is tax-transparent. This would mean that the investor can obtain the benefits of investing through an investment vehicle without suffering the double tax. The investor would be taxed as if he or she made the investment directly. For example, when the underlying investment is sold and a capital gain is realised, there would be CGT (at the individual level only) and no dividends tax.

This can be schematically demonstrated as follows:



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The last two columns in the comparison below demonstrates that if the investment is made through a tax-transparent vehicle, the tax consequences are the same as if it was made directly by an individual.

Comparison of effective tax rate of indirect investment versus direct investment	**Indirect investment**		**Indirect investment tax-transparent**		**Direct investment**	
Tax rates:						
Individual tax rate		45,00%		45,00%		45,00%
Company tax rate		28,00%		28,00%		28,00%
Effective CGT rate of individual (45% x 40%)		18,00%		18,00%		18,00%
Effective CGT rate of company (28% x 80%)		22,40%		22,40%		22,40%
Dividends tax rate		20,00%		20,00%		20,00%
Assumptions/facts:						
Proceeds on disposal of underlying investment	R	250,00	R	250,00	R	250,00
Base cost of underling investment	-R	150,00	-R	150,00	-R	150,00
Capital gain	R	100,00	R	100,00	R	100,00
Tax calculation:						
Capital gain	R	100,00	R	100,00	R	100,00
CGT thereon	-R	22,40	-R	18,00	-R	18,00
After tax capital gain	R	77,60	R	82,00	R	82,00
Distribution to investor - before tax	R	77,60	R	100,00		
Dividends tax	-R	15,52				
Distribution to investor - after tax	R	62,08	R	100,00		
Total tax on gain	R	37,92	R	18,00	R	18,00
Effective tax rate on gain		37,92%		18,00%		18,00%

Specific legislation currently exists that ensures that certain investment vehicles are free from extra layers of tax. These vehicles include Collective Investments Schemes (CIS) and Real Estate Investment Trusts (REITs), which are working well to facilitate investment in these industries. Other investment vehicles such as infrastructure funds, venture capital companies (VCC's) and private equity funds also require a similar investor friendly, enabling, dispensation. For example, even though the VCC regime provides the individual investor with an upfront tax deduction for the amount of his or her investment, the VCC regime has had limited uptake since it came into effect in 2009. We understand that one of the main impediments is the extra layer of tax which can negate the benefit of the upfront tax deduction.

C. Current flow-through options

South African investors often seek to eliminate the extra level of tax at the investment vehicle level. Mechanisms typically used are trusts or partnerships. Most foreign investors prefer to avoid the use of trusts, however, because the underlying trust law is unfamiliar and contains uncertainties. Our *en commandite* partnership rules, which are based on the common law, are often used as an alternative but can be cumbersome and archaic. Uncertainty again raises in terms of commercial law. Most foreign investors would instead prefer simplified LLC/LLP-type legislation given the common use of such legislation under the domestic law of the investor countries involved.

D. Price of inaction

The price of inaction at the domestic level is the unnecessary additional layer of tax that may prevent investment. This deterrence is especially problematic for infrastructure investments. If foreign investors are involved, the typical choice is to shift the holding vehicle offshore to Mauritius where the additional tax layer can easily be avoided. The net result is to reinforce the advantages of Mauritius as a regional hub for investment as opposed to South Africa.

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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